



IN THIS ISSUE:

- *FINANCIAL MARKET: THE RISKS OF ACCELERATED GROWTH*
- *THE COURSE OF REFORM OF THE PENSION SYSTEM IN SERBIA*
- *SERBIAN TEXTILE INDUSTRY*
- *THE GRAY ECONOMY WITH SPECIAL EMPHASIS ON BANKS*
- *THE NEW CONSTITUTION OF SERBIA
POSTULATES – DILEMMAS – SOLUTIONS*
- *SLUMP IN PRODUCTION AND RISE IN FOREIGN TRADE*
- *THE EU REVIEW*
- *THE IMPACT OF THE ENLARGEMENT OF THE EUROPEAN UNION
ON ECONOMIC INTEGRATION*

Belgrade
April 15, 2003

FINANCIAL MARKET: THE RISKS OF ACCELERATED GROWTH

Over the last two years, the domestic financial market has been subject to significant changes. In spite of high risks, the market has been growing rapidly. Turnover has increased radically and its structure has normalized.

The changed dynamics of trade (the number of transactions) and the value of transactions mainly resulted from the change in the structure of assets which are being traded. In 2002, shares were introduced on a larger scale on our market for the first time. The greatest market generator has been the Action Fund of the Republic of Serbia. Another important change in the structure of turnover is more active trade in bonds of old foreign currency savings. The short-term securities of enterprises and banks, which were dominant in the structure of turnover over the last decade almost completely disappeared.

Economic Review No. 38-39						
Serbia w/o Kosovo and Metohija: Basic Economic Indicators						
	θ 2002 θ 2001	I 2003	II 2003	II 2003 I 2003	II 2003 II 2002	I-II 2003 I-II 2002
GDP growth rate ¹	4.0%	...	...	...	...	...
Industrial production - total	1.7%	...	...	9.9%	-1.6%	-3.8%
Central Serbia	1.6%	...	...	6.1%	-4.6%	-4.2%
Vojvodina	2.1%	...	...	18.4%	4.9%	-2.9%
Average nominal net wage, in YuD	51.8%	9,468	10,367	9.5%	30.8%	29.1%
Nominal gross wage, in YuD ²	...	13,659	14,925	9.3%	30.8%	29.2%
Real growth in average net wage, in % ³	30.2%	...	...	8.6%	16.6%	14.8%
Ratio consumer basket - average net wage	-31.1%	1.2	1.1	-8.6%	-21.2%	-20.1%
Unemployment rate, registered ⁴	8.1%	31.3%	31.6%	1.3%	14.2%	13.8%
Current account, in USD million ⁵	227.8%	...	...	...	...	...
Trade balance, in USD million ⁶	39.3%	-265	-244	-8.0%	3.6%	0.8%
Exports in USD million	20.6%	161	198	23.2%	40.1%	39.1%
Imports, in USD million	31.8%	425	442	3.8%	17.2%	13.7%
Money supply (M ₁), in YuD billion. (end of period)	110.8%	119	115	-3.4%	52.5%	64.6%
Cash	122.6%	38	36	-5.3%	16.0%	29.4%
Deposit	104.6%	81	79	-2.5%	77.7%	88.1%
Real money supply, in EUR million	107.5%	1921	1831	-4.7%	45.9%	55.1%
Nabs hard curr.reserves, USD mil (end of period)	95.0%	2266	2182	-3.7%	60.3%	67.0%

Discount rate - monthly level	-77.0%	0.7%	0.7%	-9.6%	-34.0%	-39.6%
Market interest rate - monthly rate	-48.5%	1.3%	1.2%	-6.3%	-67.2%	-66.5%
Retail prices⁷	19.5%	...	...	0.3%	14.1%	14.6%
Consumer prices⁷	16.6%	...	...	0.3%	11.2%	12.1%
Producer prices	8.8%	...	...	0.0%	4.9%	4.7%
Medium exchange rate (YuD/EUR) - average	2.1%	61.95	62.78	1.3%	4.4%	4.0%
¹ Estimation						
² By the gross wage methodology applied as of June 1, 2001.						
³ Deflator is consumer price index.						
⁴ These figures include the employed in the socially-owned sector, private sector and small enterprises						
⁵ The data refer to Serbia and Montenegro						
⁶ The figures on commodity exports and imports in January were calculated on the basis of data released in the Communication no. 067 of 21 March 2003 by the Statistics Bureau of the Republic of Serbia.						
⁷ The data refer to March						
Sources: SZS, RZS, NBS, RZTR						

Market expansion is taking place in an environment that is not regulated institutionally. The financial market still lacks transparency, institutional symmetry and standard protection of investors. These imperfections strongly deform the stock market. The basic problem lies in the fact that the stock market is gradually turning into a market of enterprises. A prevailing interest on the part of buyers is to acquire a parcel of shares. There are still no institutional and individual investors on the market who would prefer yield over ownership control. This, coupled with a still unregulated macrostructure of the market, reduces the market's capacity to establish fair prices. Very often, after an acquisition of a parcel of shares, the market registers a decrease in the price and reduced turnover in shares of the particular issuer. Positive legislation does not allow regulatory bodies to work on discovering and sanctioning market manipulations (corners, pools, crossed orders). It eventually results in setting the price of shares at a level lower than the so-called equitable price.

	Number of transactions			Turnover in YuD million		
	2000	2001	2002	2000	2001	2002
Total	25.068	46.073	64.699	8.925.475	50.156.495	95.808.925

The underestimation of shares in itself accelerates the process of concentration of ownership and additionally degenerates the market. Final outcome of this process might be self-destruction of this market. Namely, it has been noticed that after acquiring a parcel of shares, the price of shares additionally decreases, as well as the number of shares in turnover and their liquidity. Ultimately, shares are being withdrawn from the market and a shareholding company closes down. In many cases this is an inevitable process. Damaging consequences of such a

practice are evident in cases when high quality share are being withdrawn from the market.

The beginning of trade in bonds issued on the basis of old foreign currency savings may be considered the beginning of the stabilization of the market. The experience of other transition countries allows for the assumption that there may be irregularities in the secondary turnover, which may result in the discrediting of this instrument and/or damage to its current or future owners. The experience of trade during last year indicates some regularities. Turnover is assumed to be growing (there is no data on how many old foreign currency depositors have sold their bonds and therefore this review does not contain such findings). A key deformation of the local market of old foreign currency savings bonds refers to it being divided into three markets which are not sufficiently connected with one another and among which arbitrage is possible.

The first market is established by every bank on its counters. The discount at this market is very deep in real terms. Information asymmetry that in part results from a complicated procedure of registration and sale often causes owners of foreign currency savings books to accept the banks' offers for the purchase of bonds at prices that are (in comparison to stock market prices) much lower.

The second market is the one between banks and other transactors. Prices on this market are neither uniform nor transparent. It is realistic to assume that the majority of turnover is performed on this market. Key players on the part of supply are banks with the highest number of depositors. This market is where capital gains from the first market are realized.

The third market is the stock exchange which has turned into a residual market. The turnover on this market is relatively small, resulting in wide variability of prices of shares on the stock exchange.

Under the circumstances of absence of an organized OTC market in our country, secondary turnover on the stock exchange is the only possibility for realizing an equitable price for these bonds. This is an important fact in terms of elementary protection of a great number of foreign currency depositors. If the stock market is confined to the residual market, where only a small portion of bonds purchased from citizens is being traded, it loses its ability to realize an equitable price. This position is confirmed by the extremely high variability of the prices of bonds. (The algorithm for establishing prices on the stock market in itself is highly standardized and has no significant impact on variability). Bearing in mind that interest rates, exchange rate differences and collectability risk strong influence the price of bonds, it may be assumed that in the absence of such risks the price of bonds would be determined by other factors which derive from the so-called macro-structure of financial markets. This concerns informal market makers of this market.

THE COURSE OF REFORM OF THE PENSION SYSTEM IN SERBIA¹

1. Introduction

The existing system of pension and disability insurance in Serbia works as pay-as-you-go (PAYG) system. All pension and disability benefits are financed from the contributions paid by present workers. For several years Serbia has been facing serious financial problems in the pension system area. Such a situation results primarily from economic factors and negative impact of these factors during the last decade. However, demographic factor is becoming increasingly significant, too.

The changes in Serbian pension system that were carried out during the 1990s were more the adjustments of the existing system than fundamental changes. They yielded certain results in terms of rationalization. However, this has not been sufficient to provide efficient servicing of beneficiaries' entitlements. Thus, in case of Serbia, the observation of international experts that rationalization is necessary, but cannot eliminate the causes of financial problems has proved right².

All relevant indicators imply that the Serbian pension system needs reform. However, because of specific characteristic of the transition in Serbia and of overall conditions in which the existing pension system was ruined, it is necessary to opt for the most efficient course of reform.

2. The Type and Structure of Pension and Disability Insurance

Serbia has a uniform system of old-age pension and disability insurance. Positive legislation allows for the possibility of organizing voluntary insurance. However, legal regulations for voluntary insurance have not been elaborated sufficiently. In spite of this, several private companies have set up their funds for pension insurance. Some of them have only internal funds for their employees, while others are open to all interested persons. Available information indicates that

¹ This paper was presented at the seminar "Pension System Reform in Serbia and the Environment for Investment Funds" that took place in Belgrade, on September 4-5, 2002, under the organization of USAid, PriceWaterhouseCoopers, "DUNAV-TBIH" Joint Stock Company for Pension Insurance, G 17 Institute and the European Bank for Reconstruction and Development.

² Piotr Bujak and Marek Gora, *Current Situation of the Pension System in Yugoslavia and the Need for Reform: International Experience with Special Emphasis On Lessons That Can be Learned From the Experience of Poland*. Analysis of the possible impact of pension system reform on the labor market and financial markets in Yugoslavia., CASE Institute, Warsaw and G17 Institute, Belgrade, December 20, 2001, Belgrade.

companies that run universal pension funds in Serbia have not achieved considerable results thus far in terms of attracting voluntary ensurees. It is possible that these companies appeared with plans that are too ambitious with regard to the material status of the majority of potential ensurees.

There are three funds within the system of mandatory pension and disability insurance in Serbia: (1) the Fund of the Employed, which involves workers employed in socially-owned, state-owned and mixed enterprises and in cooperatives, as well as those employed in small companies (both socially-owned and private); (2) the Fund of the Self-Employed, which comprises primarily the owners of private small shops; (3) the Fund of Farmers, which involves farm owners and their families (who are not insured on the basis of employment if it concerns mixed households).

According to the number of the insured and to the funds necessary for servicing benefits on the basis of pension insurance, the Fund of the Employed holds a dominant position. In 2001, the share of expenditures of the Old Age Pension and Disability Insurance (PIO) Fund of the Employed, in the total expenditures for mandatory pension and disability insurance in Serbia accounted for 93.3%, of the PIO Fund of Farmers 3.0% and of the PIO Fund of the Self-Employed 3.7%.

3. Demographic Aspects

The process of transition of the Serbian economy and society has a negative impact on the PIO Fund of the Employed mainly due to the following reasons: (1) a high number of beneficiaries of acquired benefits; (2) a strong decrease in the number of employees in the socially-owned and state-owned sectors which were the major insurance policy holders of this Fund; (3) lower salaries of employees in the socially-owned and state-owned sector in comparison to the private sector; (4) restructuring and privatization of the socially-owned and state-owned sectors and consequent irregularity in contributions paid to this Fund on behalf of employees.

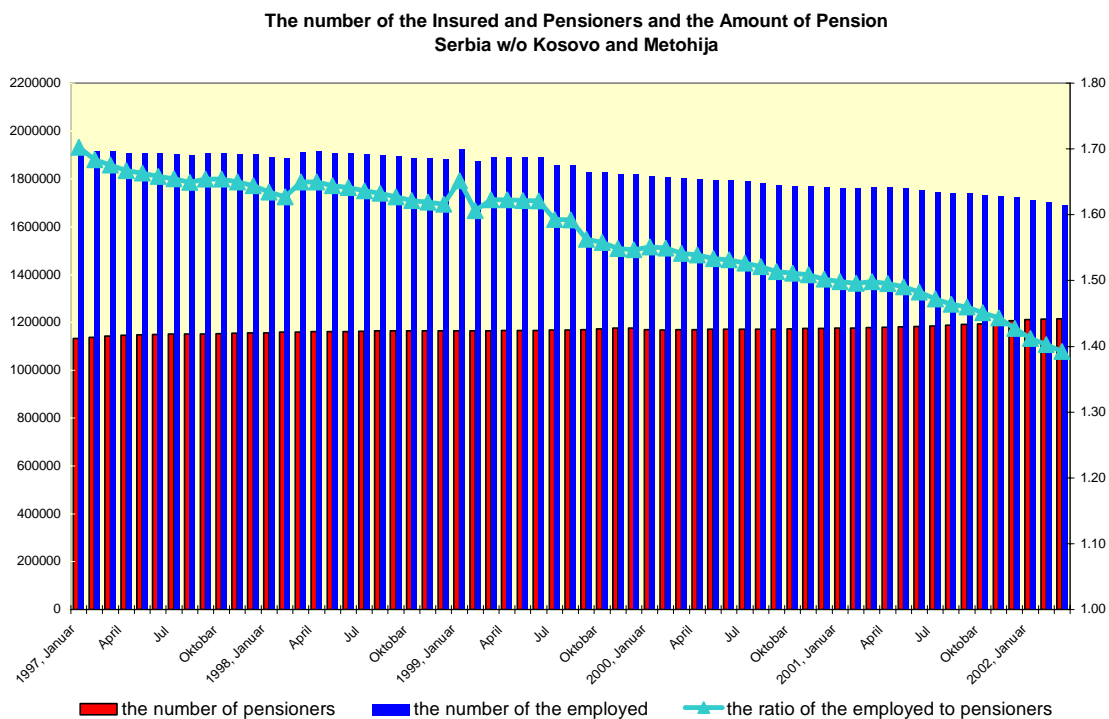
The number of pensioners has been growing at a mild pace over the last several years (from 0.4% to 0.6% on average per a year). An exception is year 2001, when the total number of pensioners increased by 1.3% compared to 2000. Faster increase in the number of pensioners in 2001 was caused by the announcement of changes in retirement conditions which came into force as of January 1, 2002.

According to the Survey of the Labor Force³, the number of employees in the socially-owned and state-owned sectors dropped by 7.7% in 2001 year-to-year, while employment in the private and mixed sectors (includes companies partially privatized in the past) and in cooperatives increased by 19.9%. In the structure of the number of employees according to the sector of ownership, Serbia has experienced significant decrease in the share of the socially-owned and state-owned sectors (from 76.9% in 2000 to 71.9% in 2001), while the share of workers in the private sector and in cooperatives has been growing (from 19.4% to 22.1%, i.e. from 3.7% to 6.0% respectively).

³ Federal Statistics Bureau

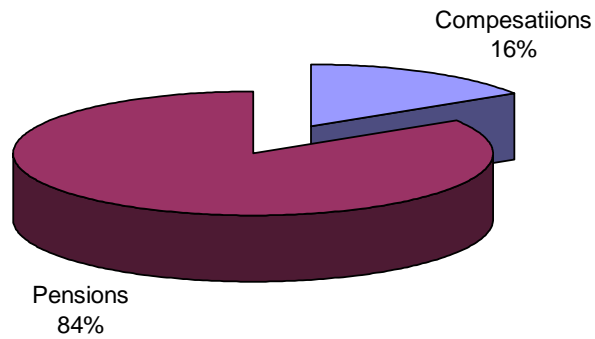
A relatively intensive process of privatization and restructuring projected for next 3-4 years is expected to result in the disappearance of social ownership, and the labor force will have to be restructured. The policy of faster development of small and medium-size enterprises and the stimulation of self-employment will result in a completely different structure of the employed. It is therefore necessary to bear in mind these facts in choosing the course of pension system reform, in particular in the implementation of future rationalization in the existing overall system of pension and disability insurance, especially with regard to the future functioning of the PIO Fund of the Employed and possible expansion of the Fund of the Self-Employed.

These reverse trends in the number of the insured and pensioners in the PIO Fund of the Employed have already brought about a very unfavorable ratio between them. In March 2002, the ratio in this Fund was one pensioner to 1.39 employed, i.e. insurance policy holder.



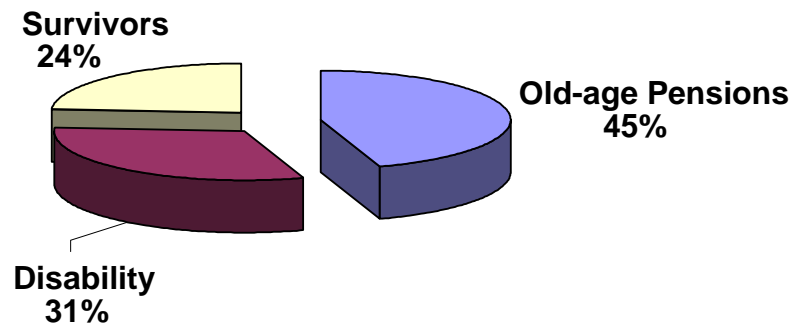
As we already mentioned, Serbia has a uniform system of pension and disability insurance. In the structure of the total number of beneficiaries of pension and disability insurance, 84% refer to pension beneficiaries, including disability pensioners, while 16% refer to other compensations deriving from pension and disability insurance.

**The Structure of Beneficiaries of Benefits on the Basis of Pension and Disability Insurance of
the Employed
March 2000**



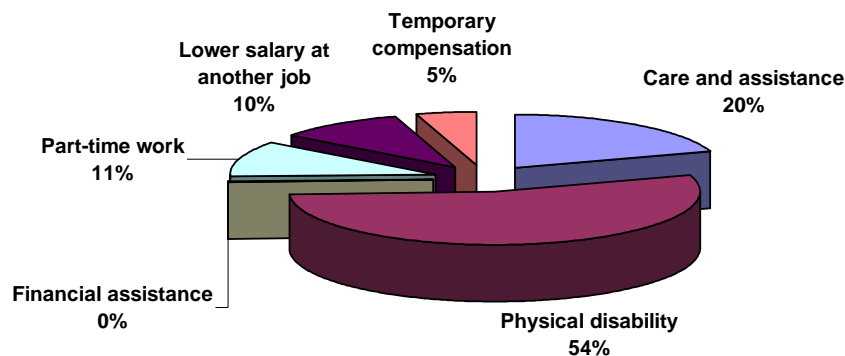
In the structure of the total number of pensioners, according to available data for March 2002, a prevailing share refers to the beneficiaries of disability pensions (31%) and survivors (24%), while the number of old-age pensioners constitutes only about 45% of the total number of pensioners in the PIO Fund of the Employed.

The Structure of Pensioners According to the Type of Pension



In the structure of beneficiaries who receive compensations on the basis of pension and disability insurance, beneficiaries with physical disabilities constitute over one half (54% in March 2002). There were 21% of employees with a certain degree of disability who received compensations, of whom 11% received compensations on the basis of part-time work, while 10% received lower salaries at another job and were entitled to compensations up to the level of the salary they would have received if they had worked at a job they used to have before becoming disabled workers.

The Structure of Compensation Beneficiaries According to the Type of Compensation
March 2002



Of the total number of beneficiaries who are entitled to compensations from the PIO Fund of the Employed, those who receive compensations on the basis of someone else's care and assistance constitute 20%. This compensation is intended for pensioners who are not able to take care of themselves due to permanent illness. It seems justified to transfer this type of compensation from the system of old-age pension and disability insurance to the system of social protection.

4. Financial Aspects

The Old-age Pension and Disability Fund of the Employed in Serbia has been facing enormous financial difficulties for a long time. Before the political changes in 2002, the Serbian Government dealt with these difficulties in the following ways: (1) it increased contribution rates (in 2000, the cumulative contribution rate to the PIO Fund of the Employed amounted to 32% of the gross salary, consisting of 50% charged to the employer and another 50% charged to the employee; (2) it had been introducing additional taxes on excise goods, financial transactions, energy sources, and various fees (possession and carrying of weapons, special fee charged for registering vehicles, etc.) which were paid both by legal entities and natural persons, including pensioners.

The pension insurance contribution rate proved to be too high for employers, especially for those from the state-owned and socially-owned, inefficient enterprises, and resulted in the reduction of net salaries of employees. On the other hand, many state-owned and socially-owned enterprises were not paying contributions for pension and disability insurance at all, as competent authorities

of the Fund and of the Serbian Government, as a rule, tolerated such infringements.

Since 1998, additional taxes and fees were paid to the so-called Government's special accounts, which were not part of the Budget of the Republic. How much money was collected and how these assets were spent is not known because the Government neither had the obligation nor felt obliged to inform Parliament and citizens about this. It was only known that the Government was thus covering the deficit in pension and disability insurance funds. Our estimate is that the amount of money directed to these funds accounts for less than 20% of the total money collected on "special" accounts.

A portion of subsidies to pension and disability funds in the total expenditure of these funds amounted to 16.2% in 1998 and to 17.2% in 2000. However, in previous years, the benefits of beneficiaries of pension and disability insurance were serviced irregularly, with great delays in payment of pensions and compensations. Moreover, pensions and compensations were not adjusted regularly, although this was prescribed by law. The share of total expenditures for pension and disability insurance in the social product (material concept of calculation) in 1998 was 19.0%, and in the gross domestic product (GDP) about 15-16.0%. Here we should mention that in 1998 "other non-business expenditures" accounted for 19.6% in the total expenditures of the PIO Fund of the Employed.

In 2001, when the pension and disability insurance contribution rate was reduced (in the PIO Fund of the Employed to 19.6%) within the fiscal reform undertaken by the new Government, the portion of subsidies from the budget of the Republic rose to 27.6%. However, as opposed to the former period, pensions and compensations from pension and disability insurance have been paid on a regular basis, being regularly adjusted as prescribed by the law. The collection of contributions has become more efficient, as well. Increase in employment in the formal sector and growth in real wages is expected to provide increasing amounts of money from contributions for mandatory pension and disability insurance, thus reducing the need for subsidies from the Budget.

The balances of the PIO Fund of the Employed were cleared in 2001. Thus, besides regular servicing of the benefits of beneficiaries of the PIO Fund of the Employed, and besides the payment of a portion of delayed pensions to beneficiaries of the PIO Fund of Farmers, the share of total expenditure for pension and disability insurance in the social product (material concept of calculation) was reduced to 12.9% in 2001, while this share is estimated to constitute 9.7% of the GDP.

Everything put forth so far brings us to the conclusion that difficulties in the operation of the pension and disability insurance funds in Serbia (except for the Fund of the Self Employed), resulted from problems in our economy before the political changes of 2000, as well as from non-economic behavior of authorities responsible for managing the system of pension and disability insurance.

5. Minor Adjustments of the System

According to the previous experiences, the efficiency of pension system reform to a significant extent depends on the efficiency of the system that is due to undergo change. The more efficient the existing system, the lower transition costs, and vice versa.

The existing pension and disability system in Serbia underwent three sets of changes during the last decade (in 1992, 1996 and 2001) which were aimed at making the system more rational. These changes mainly referred to introducing stricter retirement conditions. In that sense, results of these changes are primarily reflected in: (1) considerable slowdown in the growth of the number of pensioners; and (2) decrease in the share of disability pensioners in the total number of pensioners.

The latest changes that came into force as of January 2002 relate to (1) the raising of the retirement age; (2) the introduction of new methodology of adjustment of pension trends; and (3) establishment of the concept of a minimal pension.

The retirement age was increased by three years at once. It is still too early for any assessment of the effects of this change.

As far as the change in the methodology of pension adjustment is concerned, it may be concluded that it yields positive results. This change means that instead of the earlier practice of adjustment to the growth of the nominal net wage at the level of the Republic, adjustment now relies on combined growth of the average nominal gross wage and consumer price index growth in the Republic, on the basis of 50%:50% ratio. As for positive results of the change, the ratio of the average pension of the PIO Fund of the Employed to the average wage has become acceptable. Namely, the ratio of the average pension to the average wage after the application of new pension adjustment methodology, is 69%, and of average pension to average gross wage is 48%. It should be borne in mind that the average pension refers to all categories of pensioners: old-age and disability pensioners and survivors.

**The Average Pension, Average Net and Gross Wages and the Ratio Between Them
June 2001 – July 2002**



Also, there is still no available information for the assessment of the effects of the established concept of “minimal” pension instead of the five-level “guaranteed” pension, since the time of payment does not coincide with the time of adjustment because of a two-month delay in payment.

Changes that came into force as of January 2002 are introduced through amendments to Federal law. Amendments to the Law of Pension and Disability Insurance in Serbia still remain to be made. Some further adjustments are possible in terms of rationalization. This refers in particular to the revision of benefits from disability insurance, as well as to the transfer of the category “compensation for someone else’s care and assistance” from this system into the system of social protection. However, any changes that would change the position of future pensioners who will certainly remain in the current system during the transition period, given their age, working tenure and level of salaries, would not be acceptable.

The results of the previous analysis invite consideration about the incorporation of all three Funds into one, or at least about stricter definition of the insured who belong to a certain Fund in order to avoid unexpected transfers of the insured during the process of restructuring and privatization.

6. The Course of Reform

Experiences from all across the world show that the choice of the course of pension system reform is mainly based on the designing principle suited to specific conditions of each country. Namely, this concerns the development of a

multi-pillar system. In a multi-pillar system, each pillar has a different function and different features. However, it is important to define a final goal for the functioning of all three pillars.

With regard to the system of pension insurance in Serbia, a new system will have to provide attainment of two basic goals:

- (1) safety in maintaining real amounts of contributions for undisturbed servicing of the benefits of future pensioners, and
- (2) pension funds should become institutional investors.

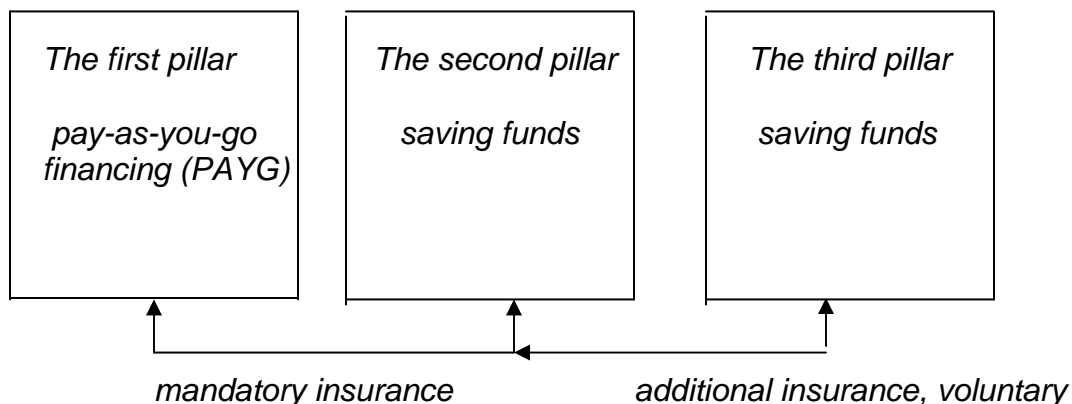
Both goals can be realized only providing the development of financial markets alongside pension reform.

However, in defining the multi-pillar system of pension insurance, it is very important to define the role of each pillar in attaining basic goals, as well as ways for their financing.

The results of analyses conducted so far indicate that the reform of the pension system in Serbia should be directed toward the establishment of three pillars:

- (1) The first pillar – mandatory pay-as-you-go system
- (2) The second pillar – fully-funded mandatory defined contribution system
- (3) The third system – voluntary insurance.

Three-Pillar System



The future of our system lies in the second and third pillars. However, a very serious question arises as to what to do now, given the situation in the Serbian economy?

The first and the second pillars are the basic ones. However, there is a difference between these two pillars in terms of financing, as well as in attaining the above mentioned pension system goals. As we have already seen, Serbia has a large number of pensioners who belong to the first pillar, but their ratio to the current number of the insured is already unfavorable. If the second pillar is to be introduced to complement the first one, it would certainly be helpful for meeting the first goal of pension system reform in the first several years, i.e. it will provide sufficient means for pay-as-you-go financing of pension benefits during the

period of transition, but it is still uncertain how much money, if any at all, would be left as savings

Moreover, there is a question of meeting the second goal of pension reform, which should enable pension funds to be at the same time institutional investors on the capital market. If it is unclear at the moment that they will really function that way, the question arises as to whether it is worthwhile introducing the second pillar as yet. It is obvious that more subtle analysis is necessary for this decision and it should be started immediately. Hence, it is necessary to start with the preparation of a scientific base for the implementation of a mandatory defined fully-funded system in the area of pension insurance for younger generations.

According to everything advanced thus far, we may get only to the introduction of the third pillar, i.e. voluntary pension insurance.

The legal possibility for voluntary insurance within the existing system has not yielded significant results so far. This may be the result of as yet insufficiently developed legal regulations. But, it is more likely because the material status of employees and all citizens of Serbia in the previous decade was very hard. In Serbia, there are some additional reasons for lack of confidence among citizens in the functioning of pyramidal savings banks in which their deposits remained "captured". It is therefore necessary to search for such forms of voluntary pension insurance which will guarantee the realization of benefits of the insured in old age.

6.1 Voluntary Pension Insurance in Enterprises

Before 1990, certain companies in Serbia were interested in establishing pension funds for their employees. It seems that this form of voluntary pension insurance would be more acceptable for both employers and workers today as a transitional, i.e. temporary form, until they realize the significance and role of independent pension funds within enterprises for overall development and until the tax base that may stimulate the development of enterprise-type independent pension funds becomes stronger. This does not mean that the second form should not be developed. Quite the opposite, legal possibilities should be created for both types of voluntary pension insurance based in enterprises. Practice will show the preferences of the insured, who at the same time should be given adequate education in order to accept such forms of pension insurance.

The interest of employees for voluntary insurance within their enterprises lies in the possibility for additional saving for old age (as compared to mandatory pension insurance). This increases security in old age.

The interest of employers lies in creating investment funds which they will be able to use, under favorable conditions, for the development of their companies. This would permit an increase in the investment potential of the company.

Voluntary pension insurance within companies can have a stimulating effect on the process of privatization and on the development of financial markets. Small shareholders in the existing mixed companies would be allowed to invest their shares into pension funds at their nominal value. Thus the pension fund would be able to appear on the open market and to trade with these shares.

In general, voluntary pension insurance organized within companies would be a sound incentive for economic development, as these funds could gradually evolve into real and universal institutional investors. It could be also beneficial for increasing employment opportunities.

7. Legal Regulations

The system of voluntary pension insurance should be regulated by a special law. This law should, above all, include the following:

- (1) obligations and benefits of the insured
- (2) obligations and benefits of employers
- (3) maintenance of real value of deposits
- (4) organization of insurance
- (5) insurance management

The state should be a guarantor for voluntary pension insurance.

8. Social Dialogue and Consensus

The introduction of the system of voluntary pension insurance in Serbia requires the widest social dialogue. This primarily relates to the agreement on:

- (1) the extent of the contribution rate
- (2) the modus for settling obligations toward pension funds and vice versa
- (3) insurance tenure, i.e. years of investment
- (4) the amount of the pension
- (5) safety and sustainability of real deposits

9. Conclusion

The reform of the pension system in Serbia is necessary. In the long run, the basic goal of reform is to establish a saving investment fund. Under the current situation we should work on developing a system of voluntary pension insurance that will rely on company savings funds. At the same time, it is necessary to start scientific research which will examine conditions for the introduction of the second pillar – a mandatory defined pension insurance based on the principle of saving funds.

SERBIAN TEXTILE INDUSTRY

Brief Review of the Situation in the Serbian Textile Industry

The situation in the textile industry and the industry of leather and footwear in Serbia is very difficult, even alarming, as the mere survival of these industries in Serbia is under question. This applies to both the socially-owned and private sectors of the textile industry. The textile industry used to be one of the leading exporting industries in the SFR Yugoslavia, with Serbia having once been the largest textile producer. Owing to business arrangements with foreign partners, this industry was operating according to all market principles followed in Western Europe for decades. However, if the downward trend, which began in 1991, continues, the textile industry will become one of the marginal industrials in the Serbian economy (the number of workers employed in this industry may drop to as few as 15-20,000). In this article we will mainly address the problems present in the textile industry, but where the situation is relevant, we will also address the industry of leather and footwear, as well.

Unless the industry itself, and especially the state, undertake radical measures, these pessimistic expectations may come true. The negative trends of 2002 have continued in 2003.

Indices of Production, Stocks and Realization in the Textile Industry of Serbia in 2002 year-to-year ¹

Indices	Production			Stocks end of XII 2002	Sale I-XII 2002 I-XII 2001
	XII 2002 XII 2001	I-XII 2002 I-XII 2001	XII 2002 XI 2001		
Industry and mining	105.3	101.7	95.4	112.3	104.8
Production of yarns and fabrics	68	77.9	77	91.5	85.8
Yarns	75.1	86.1	76.2	77.5	82.5
Fabrics	65	74.5	77.5	93.8	87.5
Finished textile products	69.9	79	89.7	88.4	79.2
Knitwear	96.3	93.9	103.9	93.2	90.9
Ready-made clothes	54.2	66.9	89.4	82.8	70.3
Other (carpets, floor coverings)	93.3	102.5	78.6	106.9	102.5

¹ Source: "The Analysis of Business Performance of the Textile, Clothing, Leather and Footwear Industry in 2002", Chamber of Commerce of Serbia, the Association of the Textile, Clothing, and Footwear Industry, Belgrade, February 2003, pg.2

In 2001 it was expected that year 2002 would be a turning point and a year of recovery for this industry. However, all economic indicators registered a further drop, with exports in the area of the textile industry in 2002 accounting for 10.4% of total industrial and mining exports in Serbia, as compared to 14.1% in 2001, coupled with a huge trade deficit. The entire section of the textile industry does not have a production index of 100 in 2002 relative to 2001, and such negative trends have continued over the first half of 2003.

Foreign Trade in the Area of Textile Industry in Serbia in 2001 and 2002 in ,000 US \$²

	EXPORTS			IMPORTS			BALANCE		
	2001	2002	Index	2001	2002	Index	2001	2002	Index
Industry and mining	1.624.613	1.885.300	116	4.048.541	5.369.977	132	-2.423.928	-3.484.677	143
Production of yarns and fabrics	36.469	22.531	62	298.233	361.788	121	-261.764	-339.257	129
Production of finished textile products	192.817	173.336	90	114.217	141.983	124	78.600	31.353	40
Total textile industry	229.286	195.867	85	412.45	503.771	122	-183.164	-307.904	168
% share of text.ind. in industry and mining	14.1	10.4	74	10.1	9.4	92	7.5	8.8	117

² Ibid. pg. 5

Over 1,000 companies operate in this industry at the present, employing about 100,000 workers. The economic and social position of these workers is very hard since wages paid out in the textile industry are the lowest compared to other branches of manufacturing.

Wages in the period January – February 2002 in YuD

Economy	10.504
Production of yarns and fabrics	4.168
Production of garments	3.218
Production of leather and leather products, footwear	5.737

Source: Belgrade Chamber of Commerce

Very few companies in this industry perform successfully, with contracted business arrangements and good prospects, while the majority of companies are

not working or have gone bankrupt, or are due to go bankrupt in the near future. As far as the process of privatization is concerned, five companies are in the process of tender privatization, seven companies have undergone the restructuring process, but progress is very slow (funding for these companies has been provided from the Transition Fund). In 2002, 82 companies in the textile industry made use of YuD 372 million of financial assistance approved as an incentive for production and exports. These assets were allocated for fixed assets and working capital, with the major portion being spent on salaries. Hence, even this meager funding, YuD 4 million per company on average, has not been used efficiently and productively; moreover, since these are not subsidies, the question is how, if at all, these assets will be returned to the state. Everything put forth so far shows a very bad situation in this branch of the Serbian economy, a problem increasingly encountered by private producers, as well. Private producers object to the state's negligence with respect to their capital and the efforts they make in order to work successfully in legal economic flows. They also stress that the Serbian textile industry has no future unless some urgent and radical measures are implemented.

Problems Facing the Serbian Textile Industry

Serbian textile industry faces the following problems:

- Enterprises are heavily indebted in terms of taxes and contributions, and their bank accounts are therefore very often blocked, which prevents them from doing business and from paying out salaries to their workers.
- The gray economy, not only in the area of sales, but also in the area of textile manufacturing. The problem of unregistered companies or companies which are registered as small workshops, although they have a significant output and employ a considerable number of workers.
- Uncontrolled imports of textile – large amounts of goods are imported at very low tariff rates or entirely free of duty, or as bogus temporary admissions. Also, a huge problem in the leather industry is the uncontrolled export of raw hides which have a complex negative impact on this industry (underutilization of the capacities of domestic companies, unnecessary imports of raw materials from abroad, poor quality of finished products, etc.). Moreover, not only has the outflow of raw material not been stopped, but it has been subjected to a liberal foreign trade regimen.
- The existence of the informal sector has a negative impact on the state because of uncollected taxes.
- Restrictive factors for exporting to EU markets.
- Inability to follow the growth of payroll taxes and contribution bases, as, under such circumstances, and due to poor business conditions (operating costs increased by 250%; export prices have dropped, instead of growing; stable foreign exchange rate of the Dinar is generally positive, but the problem is that there are no off-tariff protection measures and incentives for exports), little is left for paying decent salaries to the workers.

- The lack of motivation amongst workers.

These problems increasingly affect private textile manufacturers. Besides general ones, they report concrete problems they face while doing business.

Private manufacturers stress the lack of readiness on the part of the state to undertake a portion of its obligations, unstable business environment and consequent disrespect for capital and for the work of private manufacturers, as being among the most important problems. Businesspeople in the entire industry feel left to their own devices.

A specific feature of this industry is a dominant female labor force, and a consequent problem of maternity. Namely, the state pays out only maternity leaves at present, but not any other types of leaves; given taxes and contributions, our worker is relatively expensive for foreign partners, in spite of the quality of work involved. A foreign partner is most interested in cheap labor that we can offer, because everything else, i.e. technology and especially raw materials, can be found anywhere in the world. Despite the interest of foreign partners, even Germany, our traditional partner, is not ready to be sentimental and full of understanding for our situation, but offers very low prices for our products:

- Hourly wage norm – EUR 2
- Skirts – EUR 1
- Trousers – EUR 1.8
- Coats – EUR 5 – 5.5

These prices are still acceptable for transition countries such as Russia, Belarus, Ukraine, Bulgaria. However, these are very low prices for our industry, not because our worker is expensive, but because they are not sufficient for covering all contributions and taxes, administrative costs, accumulated debts and problems that burden production. Therefore, our manufacturers fear that foreign partners may start avoiding our country in search of cheaper labor (and go to Albania, for example), because our country is already relatively expensive for them, although the process of transition has just started.

Private manufacturers also point to the problems of the gray economy, the purchase of new technologies, high payroll tax and contribution bases, red tape, offering some suggestions as to how to resolve them (these suggestions will be mentioned together with other proposals for resolving the problems in the textile industry).

Before examining the solutions that companies consider necessary for the resolution of the current difficult situation in the textile industry, let us mention problems present in the leather and footwear industry. The main problem is uncontrolled exports of raw hide, a basic raw material in this industry. Such exports and a fully liberalized foreign trade regimen result in the underutilization of domestic capacities, poor quality of finished products and low exports. Unlike our country, other countries in transition which possess considerable capacities for leather processing, i.e. Russia, Belarus and Ukraine, pursue strict control and do not allow excessive exports of domestic raw hides. The problem of the gray economy is present in this industry, also with considerable resultant damage.

This industry used to be a significant producer and exporter of domestic products, i.e. over 20 million pairs of footwear per year, against barely two million pairs today. However, even that amount cannot be sold on the domestic market today. This industry currently directly employs about 40,000 workers, with another 80,000 workers being connected to it, which indicates its significance for the Serbian economy.

Measures and Programs for Consolidation of the Serbian Textile Industry

Textile manufacturers suggest the following urgent measures in order to save and consolidate the Serbian textile industry:

- To reorganize and recover companies, i.e. to write off their debts accumulated on the basis of unpaid taxes and contributions to the Development Fund, the Federal Bureau for Commodity Reserves, the Pension Fund, etc. and to unfreeze bank accounts of certain companies, thus enabling them to operate.
- The problem of permanently increasing payroll taxes and contribution bases should be resolved adequately in order to ensure decent salaries for workers.
- To subject to control the exports of raw hides in order to enable better utilization of domestic capacities.
- To provide off-tariff protection and incentives for exports. Private manufacturers suggest the introduction of protective prices for the import of textile products in order to defend domestic production from dumping prices of Chinese products.
- To allow the payment of turnover taxes after sales are charged because of frequent difficulties in charging realized sales.
- One of the most important incentives is the introduction of rigorous measures at all levels, both in the area of production and sales, in order to reduce the gray economy. Private manufacturers believe that the problem of the gray economy can be resolved relatively quickly and easily, provided that there is readiness on the part of the state, since even producers from Novi Pazar (who are seen as the greatest source of the gray economy) are ready for this problem to be resolved. In the opinion of private manufacturers, it is necessary to prohibit commission sales (90% of existing small shops work on commission), to reduce the red tape of the state apparatus as a potential sources of the gray economy.

Other solutions proposed by private manufacturers are as follows:

- The problem of the lack of technology as well as of outdated technology can be resolved by better organization within the industry itself. Big socially-owned systems which possess relatively good quality technology but have underutilized capacities can lease their technology for exploitation to private manufacturers who need such technology, so that private producers will not have to buy such equipment from abroad (a new industrial sewing machine costs EUR 2,500).

- To reach agreement among the manufacturers (there have been several fruitless attempts) not to contract below a minimum hourly wage of EUR 2.5, because private manufacturers will not be able to cover their expenses with the ratio of administrative to production workers of about 1 to 5, nor will socially-owned companies be able to do so where this ratio is 4 to 1 in favor of administrative workers.

These are short-term and urgent measures that are necessary to ensure the survival of the textile industry in Serbia. As far as long-term measures are concerned, several sections of the Strategy of Economic Development of Serbia address this area, but they have never been implemented in practice and are collecting dust on some shelf, which has largely been the case with similar strategies. It is necessary to adopt a national strategy of development of the textile industry of Serbia which would provide an answer to the question whether Serbia is going to have a textile industry at all, and if it the answer is positive, what is needed for its recovery and development. The strategy must present an agreement between all stakeholders, including a program of measures that must be realized in practice; otherwise, the Serbian textile industry will disappear.

From everything put forth so far, it is obvious that experience, know-how and the desire of people from this industry to resolve accumulated problems exists, but without state assistance and cooperation prospects for the future are bleak. Downward trends in the textile industry have been continuing because these solutions have not become operational and have been constantly postponed, waiting for their turn. Also, there is a problem of bad communication (or ignorance) between the state and its institutions and private manufacturers, i.e. associations on all programs and possibilities for consolidation of the textile industry.

Programs for the consolidation of the Serbian textile industry exist or are being planned by the state. Foreign investors are interested in our market and want to build it up to the level necessary for doing business on that market. German partners want to transfer their production to our country, but it is necessary first to consolidate our textile industry

With that goal, the European Bank for Reconstruction and Development prepared the project for the consolidation of our textile industry as an industry that can recover in a very short period, engage a considerable portion of our labor force and be readied for exports, thus providing necessary foreign currency. This project should start at the end of April 2003.

The German Government has taken part in the program of recovery of our textile industry since November 2002. Through its banks, the German Government approves loans for purchasing investment equipment under very favorable conditions of repayment (term of 5 – 8 years, with a 5% interest rate per year).

It is obvious that our social capacities are too big for our market. However, through cooperation with foreign partners our companies proved not to be structurally adjusted (together with our limiting circumstances) to respond to the needs of European (and world) markets which are dominated by rapid changes in fashion trends. This does not concern enormous technological delays (because certain investments were made by big socially-owned factories during

1999 and 2000), or the quality of our production labor force, but rather it concerns the lack of adequate and quality management teams (constructors, factory designers, etc.) in our companies. Foreign partners are willing to train our staff, but the long period of isolation left its mark and our staff lacks some basic knowledge which requires familiarity with computer programs necessary for designers.

Were we not devastated and overly unmotivated by the transitional depression, we could do some things on our own, i.e. the industry itself could be better organized.

It is obvious that our country is at the beginning of the process of transition and therefore we should accept low prices that are offered (which companies usually do) because of the current situation. But, prices could rise over time. Spain and Portugal, and then Hungary and Poland experienced similar situations. They attracted capital by accepting low prices, but later, as their textile industries grew and became better organized, prices also rose, and now they are able to sell their own trade marks.

We should also give up the old philosophy “to produce at all cost”, which many companies in this industry still apply, and to shift toward a market philosophy “to produce for the market”, which implies marketing approaches and definition of target groups.

Individual purchases of raw materials and equipment in foreign countries increase costs by 30-40%, which clearly imposes the need for an organized approach by our textile manufacturers in foreign countries.

Subsidies allocated for stimulating production and exports in the textile industry in 2003 amounted to YuD 437 million, out of a total of YuD 6.5 billion of subsidies projected for the whole year. Although there is room for increase of subsidies allocated for the textile industry, available assets are meager, being marginally higher than last year's, but the question is whether there exists the possibility for their efficient utilization.

The Textile Agreement with the European Union

An important problem in our textile industry is the absence of the Textile Agreement with the European Union which would ensure free access to the EU market. The inexistence of that Agreement means that our companies cannot export their products to the EU market under conditions granted to other countries which concluded such an Agreement. This Agreement is much more important for Serbia than for Montenegro, as Montenegro practically does not have a textile industry. The absence of the Agreement, together with other problems in the textile industry, results in salaries which are three times lower than the average at the level of the Republic, and there is not much interest in investing in this industry because of the impossibility of export to the EU market under competitive conditions.

Consequently, the European Union defines import quotas for the export of textile products from Serbia to the EU market. The quotas approved for this year for certain categories of textile products such as men's suits, men's and women's

jackets and knitwear have already been reached. The EU was asked to increase these quotas by 25% by April-May 2003. However, since then the Constitutional Charter of Serbia and Montenegro was adopted, the European Union offered the conclusion of the Textile Agreement by mid-2003 instead of increasing quotas. Bearing in mind the importance of this Agreement, Serbia's priority is for it to be concluded. The European Union set out the following conditions for the conclusion of this Agreement:

- Harmonization of tariff rates for textile products of Serbia and Montenegro
- Presence of one negotiator at the level of Serbia and Montenegro
- Establishment of an office in charge of issuing licenses in order to prevent abuses (re-export of textile products from countries which do not have a Textile Agreement with the European Union).
- Uniform operation of customs services (The Union accepts that Serbia and Montenegro have two custom services, but requires their uniform operation).

Because of considerable significance of this Agreement for Serbia, and because of the desire to use the offered opportunity to conclude this Agreement, the harmonization of customs tariffs for textile products of Serbia and Montenegro has been already completed.

As can be seen in the Table, according to the positive Customs tariff, Serbia used to have tariff rates on textile products that were three times higher than those in Montenegro, which is understandable because Serbia, unlike Montenegro, has something to protect with such measures. Tariff rates in Serbia ranged between 1-30% and in Montenegro between 0 - 10%. After final harmonization, tariff rates on textile products now range between 0 - 22%. Serbian negotiators took care for Serbia not to suffer two custom shocks in a short period: first with Montenegro, and later with the World Trade Organization. As can be seen, the maximum tariff rate on textile products in Serbia has not been curtailed appreciably (from 30 to 22%), while in Montenegro it was increased from 10% to 22%. The conclusion of the Textile Agreement is estimated to bring Serbia greater benefits than the reduction of tariff rates.

Leather and footwear are not included in the Textile Agreement, although the harmonization of tariff rates in Serbia and Montenegro for this industry is underway. The Serbian side tends to establish tariff rates on raw materials and intermediate products at the lowest possible level, while tariff rates on final products must be acceptable for Serbia and near levels in the European Union, although this is very difficult because Montenegro, as in the case of textiles, has tariff rates that are lower than in the EU.

Valid and Finally Harmonized Tariff Rates for Textile Products⁴

Tariff code under existing Customs tariffs	Name of goods	Range of tariff rates according to existing Customs Tariffs		Final harmonized tariff rate
		Serbia	Montenegro	
50,51,52,53,54,55	Silk; Wool; Cotton; Other vegetable textile fibers; Man-made filaments; Man-made fibers	1-10%	0-5%	0-10%
56	Wadding	5-10%	1-3%	5-10%
57	Carpets and other textile floor coverings	20%	5%	15%
58	Special woven fabrics	10-20%	5%	15%
59	Textile fabrics	1-20%	0-3%	1-15%
60	Knitted or crocheted fabrics	10%	5%	10%
61	Articles of apparel and clothing accessories, knitted and crocheted	20-30%	10%	18-22%
62	Articles of apparel and clothing accessories, not knitted and crocheted	20-30%	10%	18-22%
63	Other made-up textile articles	5-30%	5-10%	5-22%
65,66	Headgear; Umbrellas	20%	5%	5%

⁴ Source: Chamber of Commerce of Serbia, 10th Meeting of the Committee for the Textile, Clothing, Leather and Footwear Industries, speech by Zoja Stojanovic, adviser to the Association of the Textile, Clothing and Footwear Industries, Belgrade, February 27, 2003.

THE GRAY ECONOMY WITH SPECIAL EMPHASIS ON BANKS

Although the *gray economy* exists in all countries around the world, we still do not have a clear and commonly accepted definition of what the *gray economy* is all about. This is certainly due in part to the fact that the *gray economy* operates outside of legal flows; since there is no reliable data on which to base monitoring and analysis of the gray economy, it is not possible to have full insight in its operation. Since the *gray economy* is not recorded and expressed in accounting terms, this way of doing business can not be controlled at all, or the control is very difficult. In any event, it certainly concerns doing business deliberately *outside of the legal framework*, which is aimed at generating income **without**:

- Fulfilling all fiscal and other financial obligations toward the state and other institutions prescribed under positive legislation (tax evasion), and
- *Control* of business performance, which should be pursued by competent offices.

The Law on Money Laundering considers the gray economy to be the performance of unlawful activity, putting it on the same level as trade in arms and drugs.

A portion of money earned through the gray economy is directed (transferred) to legal flows. It is hard to estimate what portion this is, because it depends on the motivation of a given entity for working in the gray area. Moreover, a given entity may be legally registered, performing only one segment of its work in the gray area, e.g. the payment of salaries, avoidance of export taxes and of mandatory contributions, or just one portion of income may be in gray flows.

The following have been reported as reasons for operating in the gray economy: high taxes; high tariff rates; high contributions for social and disability insurance and other fiscal obligations; inefficient legal system; lack of confidence in the system, i.e. in the state, because of which money stays outside of legal financial institutions; low economic activity; low standard of living; too many regulations; rigid and non-transparent regulations; too intense state interventionism; complicated and long administrative procedures; inadequate protection of property and contracts; the process of transition; war; sanctions, etc. However, the most common expert opinion is that the most frequent reason for operating in the gray economy is tax evasion understood in the widest possible sense, namely, including avoidance of taxes and contributions of various kinds which are not referred to as taxes.

The gray economy may also may result from:

- The inability of an economic entity to fulfill all conditions stipulated under the law for regular work in a particular line of business, e.g. for the collection of savings, authorization of loans, etc. or its inability to respect

all quality requirements in the production and sale of certain products, e.g. in the food processing industry.

- Intention to operate in the gray economy only temporarily and for that reason an economic entity considers that it is not worthwhile wasting time and money on the organization of regular work.

Of course, a subjective estimate of an economic entity that it is not financially profitable to work according to regulations may appear as a reason for operating in the gray economy, as well.

Given a great number of possible reasons that may appear in practice, and excluding commonly present tax evasion, it is sometimes very difficult to establish a real predominant reason for operating in the gray area, as well as to define the distinction between the gray and black economies. Also it is very difficult to establish what are the practical direct and especially indirect incentives for the gray economy. For example, whether strict application of the procedure and parameters for evaluation of credit solvency of a borrower by the bank (it normally requires slews of documents, analysis, information on business performance and financial status) simply forces clients into the gray economy; whether the policy of high interest rates of formal (legal) creditors (banks), and the policy of low interest rates of informal creditors who operate in the gray area also stand for incentives for the gray economy?

The size of the gray economy certainly depends on several factors. Besides the reasons which are easily and directly connected with operating in the gray area, there are some causes which are stimulative for the gray economy in a more indirect way. These include:

- **State inefficiency** in all three pillars of power: legislative, judicial and executive;
- **Imbalance** between legislative, judicial and executive power.
- **Unresolved ownership issues** and difficulties in free contracting;
- **Underdevelopment of a modern** financial system, in particular the fiscal system and the system of payment operations.

These are minimum prerequisites for a **confidence** in the state and in the financial system, and without these any efficient control of legality of business operations is not possible, neither is there a realistic fear of **consequences**. In the case of Serbia the problem of the gray economy is even more complicated, given the long period of isolation from the international community, sanctions, the unresolved status of Kosovo and Metohija, as well as the still unresolved relations between Serbia and Montenegro, which continue to have, both *de facto* and *de iure*, two completely autonomous economic systems.

In spite of damaging effects, we must be aware of the positive contribution of the gray economy in the conditions of war, civil unrests, sanctions, etc. when authorities (the state) were not capable of ensuring normal conditions for work and for doing business.

Link Between the Gray Economy and the Banking Sector

Although the problem of the gray economy appears in different forms with regard to the flows of goods and money, business operations in the gray area can hardly be present only in one sector, without direct consequences for other sectors.

Although it is hard to make a precise distinction, the link between the gray economy and the banking sector exists in two forms:

- The bank itself operates in the gray area
- The bank finances clients which operate in the gray area.

Given the very nature of banking, as opposed to the real sector of the economy, it is not easy to provide banking services in the gray area. The provision of particular banking services outside of legal regulations, for example, facilitates illicit transfers of foreign currency from the country, purchasing of foreign currency at the black market exchange rate, withholding cash from regular payment operations, etc. and can not be treated as the gray economy in the sense of a way of doing business, but as an abuse and as violation of law with or without self interest, or as a consequence of ignorance of bank clerks. The existence of intention for operating without respecting regulations and frequency (size) of operations in the gray area creates the gray economy, and not sporadic and individual transactions, although the final results of these two kinds of operations are the same.

The gray economy does not exist in cases when a bank does not keep to the standards of sound, conscientious performance, i.e. prudential regulations, either.

Illicit actions (accidental, intentional, due to ignorance) exist also in these banks which were founded in a legal way and which operate in legal flows in general. These are single incident situations, i.e. "incident activities" which are observed and prevented by internal and external control of the bank, as well as by the controlling officials of the National Bank of Serbia and other competent institutions. The more efficient the mentioned controls, the less frequent the incident satiations.

The gray economy as a rule takes place through cash transactions, while incident activities are performed and disguised by non-cash instruments, which are also discoverable but only by experts. It is logical that the volume of cash transactions follows the growth of the gray economy and vice versa.

In Serbia today it is hard to perform banking operations in the gray area. This does not mean that incident bank transactions do not exist. To what extent they do depends primarily on the bank's owner and the bank's controlling bodies, as well as on the efficiency of the state and monetary authorities. Experts for this area claim that there is no country without a gray economy. Only the USA and Switzerland are referred to as states in which the gray economy constitutes less than 10% of the GDP, while in some other countries this proportion (under certain circumstances) is as high as 50%.

The Influence of Banks on the Gray Economy

Banking is by its very nature an activity not very convenient for the gray economy. As soon as money enters the bank, it is hard, or at least much harder to operate illegally in the gray area, on a long-term regular basis and in high volume, because the control of banking operations to a great extent includes the control of business operations of banks' clients.

Actors in the gray economy try to stay away from banks because business operations through banks are recorded, money deposits are registered, etc; moreover, the gray economy directly damages bank's interest, i.e. the owners, it harms its solvency and sound performance.

The conditions and procedure of borrowing to citizens and enterprises by banks significantly decreases the possibility of operating in the gray area since the approval of a loan and the amount of the loan directly depend on the status of accounts and information on business performance of the borrower, on its clients (the principle of familiarity with clients), what is the borrower's market share, how stable is the bank's cooperation with individual clients, etc. The amount of the possible loan depends also on the amount and stability of income, total cash flow in terms of fulfilling existing obligations, etc. Thus the borrowers are forced to present their business performance and income realistically in order to obtain higher loans under more favorable financial conditions.

The introduction of modern forms of banking operations and the provision of banking services, as well as the application of sophisticated banking products (bank cards, e-banking, etc.) also make banking operations in the gray area much more difficult.

Of course, bank fees and other costs charged by banks also affect the gray economy, although not decisively.

The influence of banks in fighting the gray economy is hardly small, but is not of key importance as the banks "only" carry out payment orders and can only have a certain role in that respect. For reducing the gray economy it is much more important to know what goes on before and after the issuance of payment orders, with other institutions being in charge of control in that area.

Reduction of the Gray Economy

It is clear that the reduction of and the fight against the gray economy is a process that should involve many state institutions (organizations), requiring their full mutual cooperation and coordination. The role of the financial sector (which in our country is composed mainly of banks and stock exchanges, the Commission of Securities, brokerage and dealer houses and the Central Register of Securities), is of special importance as operations in the gray area must be

reflected in money flows, directly or indirectly, in this or that way, in one form or another, sooner or later.

Efforts made so far by the state and especially by the National Bank of Serbia in the reduction of the gray economy are indisputable:

- Business operations in the country and abroad have been liberalized;
- Intensive efforts have been put into deregulation and there is an increasing number of laws which stipulate the principle that *everything which is not explicitly forbidden is allowed*;
- Inflation has been reduced;
- The foreign exchange rate against the Dinar is stable and the gray economy in the area of foreign exchange transactions and exchange operations has been minimized;
- Payments in foreign currency have been allowed in transactions which are numerous and where abuses are very possible: the sale and rent of business premises and real estate, life insurance, sale and purchase of securities which are made on foreign currencies, payment of effective foreign currency from foreign currency saving books, etc.

The reduction of the gray economy is significantly contributed by the reform and rehabilitation of the banking sector.

Also, from the aspect of business performance of banks and the reduction of the gray economy, it is important to regulate the area of registration of real estate in appropriate registers, not only for the sake of legalization of purchases and sales, but also for expressing realistic balances and income, which is, again, very important for financing the economy and the population.

The introduction of a value added tax will certainly contribute to the reduction of the gray economy.

THE CONCLUSIONS OF THE ROUNDTABLE WHICH ADDRESSED THE PROBLEM OF THE GRAY ECONOMY

Kristian Vukojičić

The gray economy can be divided into three groups. The first group, a so called "black economy", is composed of the most profitable activities which are strictly forbidden by the law. This category includes, for example, trade in drugs, arms, people and prostitution. As opposed to the "black economy", there is a third category which includes a wide range of activities that may be called "do it yourself". This group comprises all those activities that we do, and for which we could (should) engage a professional who makes a living doing these activities and who pays taxes on that basis (e.g. painting, plumbing, etc). The second group, a central category of the gray economy and a topic of a roundtable which was held on March 20, 2003, in the G 17 Institute is a set of activities and business transactions which are performed outside of regular flows with the final

aim of evading taxes and other contributions that are mandatory in real transactions.

This article is a continuation of the research on the gray economy (basic results were presented in the G 17 Institute Economic Review December 2002 – January 2003). The roundtable was aimed at approaching this problem from the position of banks and at identifying problems which were not included in previous research. The roundtable included the Vice Governor Radovan Jelašić as a representative of the regulator, Professor Veroljub Dugalić, as a president of the Association of Banks, Milko Štimac, G17 Institute CEO, and representatives of banks, brokerage houses and insurance companies.

The gray economy is a big unknown in our society. It should be examined from all perspectives as this is the only way to obtain answers to the following questions:

- **How do the citizens of Serbia earn their living?**

Why is the value of the average consumers basket higher than the average wage and for how long is this going to last?

- **How is the trade deficit covered?**

The trade deficit amounts to nearly US\$ 4 billion at an annual level.

- **What will be the overall effect of legalization?**

Primarily from the position of fiscal revenues, i.e. what would be the additional fiscal revenues of the Ministry of Finance in terms of taxes, customs, etc. Then, what would be the effect on the growth of foreign investments after elimination of disloyal competition which is generated by gray flows. Finally, how could the strengthening of competition through the reduction of the gray economy (as disloyal competition) lead to price cuts?

The conclusion was that possibilities for the development of the gray economy in the banking sector are small, and a distinction should be made between the gray economy and illicit activities that are performed in the banking sector. Differences in interest rates may have their causes in the gray economy, but they are also a legitimate instrument of business policies of banks. Therefore, from the point of view of supervision of banks, special attention should be paid to credits authorized with interest rates lower than 1% or higher than 4% at a monthly level. Also, the problems of draining-off of money from banks to economic subjects (on the basis of interest rates or on other bases) will exist as long as there is no clear ownership structure in all economic subjects. Also, the very existence of internal banks raises suspicion and opens the possibility for the development of non-economies (dissolution of property) under the conditions of mixed ownership. However, a constructive approach to resolving the problem of the gray economy from the position of banks may appear in the form of the identification of activities which belong to the gray area and a refusal to finance these activities, but if banks know exactly what the gray economy is and if all those activities could be included, they would probably not be the gray economy any further, as all those activities would be regulated and subjected to taxation.

Special attention should be paid to borrowing outside the banking sector. The question is how to minimize (to a tolerable level) these borrowings. Some laws regulate this area, but they essentially treat the effects and not the causes. The only successful long-term solution might be lower interest rates and more favorable conditions for obtaining loans; until then, this problem will continue to exist. This opinion opened the dilemma "whether rigidity in authorizing loans stimulates or reduces the gray economy". It was also concluded that so far the principle of incentives and not of repression have been applied, and that it will be necessary in future to enforce more sanctions. Lower interest rates can be achieved (from the banks' perspective) by strengthening competition, but it was also observed that "foreign" banks "have easily got used to domestic percents" and the mentioned "solidarity about costs" is used for smoothing out the high costs of entry onto the domestic market.

The question of EUR 4 billion that remains outside of the banking sector after monetary conversion raises the dilemma whether these funds belong to the minority or to the majority. If the majority is at issue, then the question is what else should be done for small dispersed sums to be concentrated in order to provide a significant and stable credit potential. If the minority is at issue, then there is a question of consensus at the level of the society as a whole – i.e. whether extra profiteers and other persons who earned their fortunes in a dubious way should be overlooked, and whether a portion of the money should be attracted into official business flows in this way, or whether to continue with a consistent policy, thus preventing a portion of that money from gaining economic potential.

The gray economy is identified as a source of corruption (and of organized crime) which is developing in the direction of creation of parallel societies due to the impossibility (lack of motivation or incapability) of entering legal flows. Therefore there is insistence not only on examining the problem from the position of details but also in terms of applicability (who should do what? who should be in charge of including into legal flows the estimated 26% of the gray economy?).

The question of agricultural production opens several problems. Firstly, the significant amount of money which is in circulation, especially during the season. Secondly, the question of seasonal labor. Thirdly, terms for crediting agricultural production because of a one-year production process. This problem opens the question of motivation of banks to finance agricultural production in a situation in which activities with a faster turnover ensure better gain. As a solution, the state should set up a fund through fiscal mechanisms when it estimates that agricultural production is important, and through this fund the state could support those activities of interest, while banks should be governed by their own interests.

With sufficient optimism present during the roundtable, the conclusion was that a long time will pass until the sector of small and medium enterprises can be legalized and until a series of comparable balances can be created, balances that

are necessary for the evaluation of solvency and the credit rating of clients. A stable exchange rate, low interest rates and the process of decentralization are also important for the transition of the gray economy into legal flows.

A roundtable organized by the G 17 Institute

THE NEW CONSTITUTION OF SERBIA: POSTULATES – DILEMMAS – SOLUTIONS

On February 22, 2003, the G17 Institute, in cooperation with GTZ, a German organization for technical cooperation, and the Conrad Adenauer Foundation, organized a meeting of experts on the topic **“The New Constitution of Serbia: Postulates – Dilemmas – Solutions”**.

Milko Štimac, the G 17 Institute CEO welcomed participants. Mr. Štimac thanked the GTZ Center and the Conrad Adenauer Foundation for assisting this conference in organizational and financial terms.

The conference was opened by **Aleksandra Jovanović**, Head of G 17 Institute Department for Institutional Reforms, stressing that this conference is a part of a wider project “The monitoring of Institutional and Legal Reforms”, which is funded by GTZ, while this particular conference was realized with the assistance of the Conrad Adenauer Foundation.

Professor Jovanović stressed that the necessity for adopting a new constitution has opened a range of issues among experts, with the expectation that year 2003 will be written down in the constitutional history of Serbia as a year of breaking up with the past and laying down the foundations for new societal, political and economic organization of Serbia. Professor Jovanović gave a brief overview of crucial moments in the modern constitutional history of Serbia.

The new Constitution of Serbia should be a foothold for new fundamental institutional changes in our country. The transition and economic and social issues and problems that arise out of legal and economic reforms in Serbia, as well as issues related to the constitutional framework of the state union of Serbia and Montenegro, prompted an experts’ debate on open issues and possible solutions in a new and democratic Constitution of Serbia.

Beginning with the solutions offered in three drafts and one model of principles of the Constitution of Serbia, special attention was paid to the establishment and structure of power, territorial organization of Serbia and the procedure for amending the constitution, Professor Jovanović concluded.

A Comparative Analysis of the Existing Proposals and Drafts

Miroljub Labus, Professor at the Faculty of Law in Belgrade stressed that this concerns both expert and political debate. A constitution is not only a legal act of the constitutional will, but is also a process that has been initiated, and in our country this process should be continued in an appropriate way. The political parties G17 PLUS and the Democratic Party of Serbia agreed that such a debate

on open constitutional issues is necessary, and that it is open for all other parties and political subjects. Professor Labus pointed out that we live in a time of uncertainty, both constitutional and political. The Constitutional Charter of the State Union of Serbia and Montenegro has been adopted, but since it is scheduled to last three year for the beginning, constitutional uncertainty has not been resolved yet. On the other hand, there is political uncertainty, as well; but, the debate on fundamental issues should not compromise state institutions, but quite the opposite, it should stabilize them. In Professor Labus's opinion, we are in a position to enact the new Constitution of Serbia in less than six months.

The G 17 PLUS has prepared two sets of materials. One paper contains an outline of comparative analyses of the existing Constitution, three completed drafts (one created by the Belgrade Centre for Human Rights, the Constitution of the Serbia Kingdom by Professor Pavle Nikolic, and a Constitutional model made by the Forum Iuris) and constitutional principles of the Democratic Party of Serbia. The second paper contains a combination of materials made by the working group of the Democratic Party, which discusses fundamental constitutional principles and an article by Slobodan Vučetić, which Professor Labus used in his comparative analysis with regard to principles.

In Professor Labus's view, the comparative analysis of the all existing constitutions contains eleven open issues, two of which are of great importance: the territorial organization of power and the status of Kosovo and Metohija in the new Serbian constitution. Other issues are also open, but in Professor Labus's opinion, if there is good will, they could be resolved much faster and easier than it is presently believed. Professor Labus called on participants to forget their narrow political party interests, and to have in mind Serbia in year 2007-2008, at the threshold of membership in the European Union, and to use that picture as a basis for the discussion on what kind of constitution Serbia needs. It is also necessary to set up a committee to work out the other two difficult issues. However, Professor Labus has reservations that the Committee is not well-balanced, giving advantage to one idea of the Constitution over others. He is afraid that a sequential approach, which starts with procedural issues and continues with fundamental ones, could end up with a discussion on fundamental issues during the debate on procedure, and consequently, the debate on procedural issues may delay the adoption of the Constitution. Professor Labus advocates a two-track solution – for procedural issues to be discussed on one side and fundamental issues on the other, while progress in one area may be a precondition for progress in the other.

Professor Labus also discussed eleven open issues. The first issue refers to the procedure of the adoption of the Constitution. For this issue, too, a Committee will be set up to work out appropriate proposals and solutions. However, Professor Labus believes that several principles are important at this point. Firstly, the principle of credibility, i.e. a solution must not be imposed. On the other hand, pragmatism is also necessary, as we should adopt the Constitution in a relatively short period (by the end of the year). Finally, the principle of legality,

i.e. whether to amend the Constitution by applying existing regulations or not. With regard to legality, in Professor Labus's opinion, a precedent has already been made, since the FRY Constitution was not amended in the way prescribed under the Constitution, i.e. the willingness for rewriting the constitution is manifest, and this principle should be applied to the new Constitution of Serbia, as well.

Another question is the character of the state. Existing drafts do not differ considerably in that respect. All of them foresee a civil, democratic and multiethnic state and this is undisputable.

Another really difficult and open issue is the decentralization of power, or territorial organization of power. Professor Labus pointed to the difference between the sovereignty of the Republic as a state, and of other forms of territorial organization of power such as provinces and municipalities. Probable problems refer to the division of sovereignty, the reservation of legislative and perhaps judicial authority at the level of provinces in the areas in which provinces hold legislative power under the Constitution, the division of Serbia into regions, i.e. the question of their symmetrical or asymmetrical status. All of these are open issues which need to be discussed. In Professor Labus's opinion, it is important to connect the two processes, the process of wider decentralization, regardless of the structure of power we opt for, and the process of European integration. Greater decentralization may be ethnically based. Existing fears may be dispelled by speeding up the process of European integration, and then ethnic communities and national minorities would be ensured rights which are guaranteed all over the European Union, with the appropriate institutions to safeguard these rights.

Another open and difficult issue is Kosovo and Metohija. The current situation is that Kosovo and Metohija enjoys full autonomy, exercising legislative and executive power, while judicial power is limited by the rights of UNMIK, i.e. of the High Representative who has the power of veto over certain decisions. Professor Labus believes that Kosovo should be granted higher status than Vojvodina, while Vojvodina should be granted higher status than it has today, including full legislative and executive power, and full judicial power, except for powers in the area of the protection of human rights, which must remain at the level of Serbia. Of course, the issue of regions is also very important, especially for the northern part of Kosovo and Metohija.

The issue of the president of the state is also important. This is a highly politicized issue, but in Professor Labus's opinion, this should be discussed from the perspective of Serbia in 2008 and not of Serbia in 2003. The issue of a strong or weak president is closely related to the question of easier or more complex procedure of presidential elections. Professor Labus wonders whether it is necessary to change the entire procedure now, as the adoption of an easy procedure for the election of a president must affect the president's authority. Closely related is the issue of election rolls, which is important, but this should not be regulated by the Constitution. The issue of election rolls must be resolved,

at the same time as the issue of a mandatory turnout at presidential elections is resolved.

As far as the government is concerned, it is not open to too much debate, but it is interesting that all proposals foresee a strong government. Professor Labus stressed once again that the issue of a strong or weak government should be considered with regard to Serbia 2008.

Another interesting issue is the structure of the parliament, i.e. whether we need a unicameral or bicameral parliament. Professor Labus stressed that all those drafts which advocate regionalization are consistently proposing a bicameral parliament, while those drafts which are against regionalization propose a unicameral parliament.

The judiciary is also an open issue. There is an ongoing debate on who should elect judges and prosecutors and how these officials should be appointed. It is necessary to distinguish two issues - lustration, a process that needs to be completed, and, on the other hand, for judges and prosecutors, who must perform their duty professionally, to be allowed to remain in office until retirement. It is important to stress that all constitutional drafts propose a double election key. According to the political key, the Parliament should be in charge of appointing judges, although there is also a proposal that they should be appointed by the President. The second one is an expert key, according to which the High Judicial Council would propose judges. This double key should be opted for.

The last issue is constitutional appeal. This is a novelty that should be taken into consideration and discussed.

Professor Labus concluded that there are not so many open issues that they ought to stand in the way of completion of the new Constitution by the end of this year.

The Structure of Power in a Democratic Serbia

Slobodan Samardžić, Professor at the Faculty of Political Science in Belgrade discussed the structure of power in a democratic Serbia.

Serbia has begun to deal with constitutional issues only two years after political changes transpired. The reasons for such a delay are well-known, but only partially justified. This does not merely concern irretrievably lost time, but also the fact that today conditions for change of the Constitution are finally present; however, Serbia will have to create its overall political, pre-Constitutional consensus again, Professor Samardžić stressed.

One of the central points of constitutions in general, including the one in Serbia, is the structure of power. This has been an unregulated area since 1990. The structure of power should express an optimal constitutional framework for the emerging democratic system in Serbia. The emphasis is on political reality of Serbia today and on a political projection which should express an achievable

idea of its democratic organization in the near future, as well as looking many years ahead.

To all appearances, the main problem in the structure of power will concern the relation between legislative and executive powers in the triangle of three institutions – Parliament, Government and the President of the Republic. There is no great constitutional conflict with regard to independent judicial power and its relation toward other two branches of power, while the solutions adopted in this area can not affect significantly the type and form of the structure of power. On the other hand, the issue of constitutional organization of the legislative and the executive, and of their mutual relation, directly determine the essence of the structure of power. Our task, as Professor Samardžić stressed, is not to search for a theoretically optimal model, or for the application of the model which successfully exists somewhere else, but to present elements for the structure of power, applicable in practice, which are capable of satisfying the principal standards of legitimacy, legality and efficiency.

As far as the parliament and its relation to the government is concerned, the following may appear as a constitutional dilemma: whether to establish a permanent monitoring and guidance of the government by the parliament (for example, through more frequent reporting on the Government's work before the Parliament), or occasional control which is more common in parliamentary systems (deputy questions, vote of non-confidence, interpellation, which would exist as additional mechanisms besides permanent control). As Professor Samardžić stressed, we can see both examples in comparative constitutional practice of former socialist countries. But, it is obvious that neither of the two examples suits the circumstances present in Serbia today; namely, it is not usual (for public figures) here to respect laws, and we do not have a stable system of political parties. Under such circumstances, no Constitution can make a difference.

For everything advanced so far, Professor Samardžić believes that the Serbian Parliament will apparently be a weaker link in the chain of political institutions. As long as our party scene is as complex as it is and all channels of parliamentary life depend on numerous interest groups, the Government will keep having a dominant role. An unstable Parliament produces a falsely strong Government, which exhausts itself in a desperate search for a parliamentary majority. Assuming good electoral results, elections can ease that problem, but they cannot bring about a systematic solution, at least not until the political scene stabilizes. Because of this, the role of the President has an essential significance in Serbia today. Only the President of the Republic, empowered by the Constitution, can establish the necessary balance between a weak parliament, which must become stronger, and a dominant government.

In Professor Samardžić's opinion, the President of the Republic should have original popular legitimacy, i.e. be a directly elected state institution. However, this institution should not necessarily result in strong constitutional prerogatives of the president, especially not too strong in relation to the Government. The

Government should have free maneuvering space within executive power, which is ensured in relation to parliament by the mechanisms of so called rational parliamentarism: constructive censure, the passage of a certain period of time between the proposal for a vote of non-confidence and the actual voting, the impossibility of a new proposal for a vote of non-confidence during a certain period of time, etc. However, with regard to the Parliament, the President of the Republic would have the power of suspensive veto. Exercising this power, the President, as a directly elected institution, would draw public attention to a certain important decision of the Parliament on which ultimately he/she has no influence.

Professor Samardžić stressed three main reasons for the original electoral legitimacy of the President of the Republic. Firstly, the already mentioned structural problem of Serbian parliamentarianism reflected in the uncontrolled hyper-pluralism of political parties and the lack of differentiation in terms of programs and politics at the political party level. The second reason for opting for this solution lies in probable constitutional decentralization of power if it is to be realized by applying any concept of regionalism. Under such a scenario, the state would need an institution to be a political and symbolic safeguard of unity (in terms of the political community) and a political moderator of its complex institutional structure. The best solution for this institution is to function as a directly elected official. The final reason is contained in the provisions of the Constitutional Charter of Serbia and Montenegro on the High Defense Council. Montenegro will, to all appearances, keep the institution of direct election of the President of the Republic. Coupled with the President of the State Union, it would be natural for Serbia to have its representative in this Council who has the authority of direct election.

In Professor Samardžić's opinion, Parliament should be bicameral. One chamber should be a general political representation, while the other should be the representation of regions. The principal systemic question is the relation between the chambers, their powers and participation in the decision making process. In that respect, joint decision-making of the two chambers should be avoided in the areas of general interests of the Republic of Serbia, e.g. the election and dismissal of the government, budgetary issues, state symbols, enactment of laws of general significance. All these issues should be an exclusive prerogative of the general chamber of the parliament. A bicameral decision-making process would be applied in all other areas of the Parliament's prerogatives, providing that in disputes on joint solutions, the advantage should be given to the general representative chamber.

The Government should be granted specific constitutional authority with regard to regionalization, as well. It would take care operationally of the unity of the structure of power, instead of the President of the Republic, who would primarily represent symbolically the unity of the state. The Government would be entitled to initiate judicial review of regional enactments before the Constitutional Court, if it finds them not to comply with laws and other general enactments of the

Republic. The Government would also be granted the power to initiate the procedure of dismissal of regional officials before the Constitutional Court if they violate the Constitution and laws in office. Without such supervisory authority, regionalism could develop some unwanted attributes.

However, the Constitution would have to protect the regions from unwanted acts of central authorities through the right of constitutional appeal for all cases when the government, or any other state institution, acts by confining their constitutional rights. Moreover, the regions should have the power to initiate the judicial review of laws and general enactments of the Republic before the Constitutional Court if those acts violate their autonomous rights.

The presented model of the structure of power in the new Constitution of Serbia is specially designed for the parliamentary system of Serbia, i.e. it is the most appropriate form for accomplishing the main tasks that should be resolved by the constitution of one specific country in transition. That is the model of rational parliamentarism with a strong President of State applied to a state with regional organizational structure.

Bearing in mind the situation in Serbia today, and the way it should look, the constitutional structure of power turns into the question of a rational choice for the whole of Serbia, Professor Samardžić concluded.

The Procedure for Revision of the Constitution – Capacities for Legitimacy

Marijana Pajvančić, Professor at the Faculty of Law in Novi Sad discussed the procedure of constitutional revision from the viewpoint of capacities for legitimacy of the procedure, i.e. not as a technical, but as substantive constitutional issue.

When a debate on constitutional issues starts in one community, it is necessary to have a clear idea of the subject of the constitutional power (who adopts the Constitution), of how constitutional consensus can be reached (the procedure for the adoption of the Constitution) and on the social environment in which the Constitution is adopted (the moment of adoption).

Professor Pajvančić stressed that, in countries in transition, the question of how to arrive at a new constitution raises a previous fundamental question of the constitutional process.

Constitutional revision has its substantive and procedural aspects. The substantive aspect is a basis of legitimacy, while the procedural one is the measure of legality. Readiness to respect and accept that both these components of the constitutional process have equal significance increases prospects for the establishment of the constitutional state and restores the credibility of the Constitution. It relegates the Constitution to the place which it should have in one community (as a founding act) and in the legal system (as a fundamental and the ultimate legal enactments).

Professor Pajvančić responded to the question of why constitutional revision is so important, stressing that it defines the rules of agreement on basic social consensus on foundations of the community, which are accepted and respected by all (both citizens and authorities), because it facilitates dialogue on the new identity of the community, and because it gives democratic legitimacy to the constitutional process.

Professor Pajvančić further stressed that the societal environment in which the constitution is to be adopted should be taken into account as well. Two points are of special importance - essential differences between the conditions of emergence of a political community in the West and the conditions in which it is established in post-communist countries, and fear as a potential obstacle to changes (the fear of resurgence of authoritarian regimes and possible social collapse resulting from changes) that affect developments and outcomes of the constitutional debate.

The constitutional debate so far shows that readiness for respect for the standards of human rights and the primacy of basic rights exists. There are no significant disputes with regard to the concept of limited government, either, even to the horizontal division of power in the form of parliamentarism. A fundamental disagreement has appeared regarding the concepts of vertical division of power, the definition of community, the position of the President of the Republic.

As Professor Pajvančić stressed, during the debate on the procedure of the adoption of the constitution it is important to bear in mind that procedural legitimacy may stimulate and facilitate constitutional transition. But, it can also be a serious obstacle to constitutional changes. The selection of the procedure of constitutional revision is therefore a precluded and a very important issue. Professor Pajvančić referred to the paper on the method of adopting the Constitution by Professor Dragor Hiber, where he points out four issues that determine the debate on the procedure of constitutional revision: legality, representation, (dis)continuity, functionality of the procedure, while Professor Pajvančić added to these the consensus on the procedure of constitutional revision.

There are two possibilities for selecting the procedure of constitutional revision. The first one is to amend the Constitution with full respect of the existing procedure for constitutional revision (constitutional continuity). The second one is to amend the Constitution without respecting the procedure prescribed under the current Constitution (constitutional discontinuity).

The first solution respects the principle of the rule of law as fundamental in a constitutional state. It seems therefore very difficult to defend the position that a constitutional state can be established by violating the law. However, the proper question is if there exists a legal system on which the constitutional process for the establishment of constitutional democracy may rely, is it then possible to amend the Constitution while preserving legal continuity with a regime that is

under dispute. Professor Pajvančić stressed that the existing procedure of constitutional revision is very strict, containing a range of limitations.

The choice of method for constitutional revision, in Professor Pajvančić's opinion, is not acceptable for fundamental reasons. A new union does not have (neither should it) continuity in terms of contents with the previous one. Quite the opposite, a condition for its establishment is a clearly expressed discontinuity.

The violation of the existing procedure of constitutional revision does not necessarily mean absence of procedure. Quite the opposite, constitutional discontinuity does not deny the procedure, but puts forward new procedural rules. Therefore constitutional discontinuity as the first step entails consensus of relevant social and political forces with regard to the procedure for the adoption of the constitution. The debate on the procedure for revising the constitution held so far implies that advantage is given to procedures that are different from the one postulated under the current Constitution. Agreement on this issue seems to be the first step toward consensus on procedure, Professor Pajvančić stressed.

Professor Pajvančić also discussed alternative procedures of constitutional revision. A constitutional assembly, as one of the alternatives, denies the legitimacy of the existing constitutional framework. The adoption of a constitution by such a special assembly presents a constitution of discontinuity. However, this alternative does not meet with any principal objections. It is possible to call elections for a constitutional assembly during a limited period of time, providing that there is consensus between the actors of societal changes and the citizens on the need to redefine the fundamentals of the community. In Serbia, we missed that moment. At present, elections for a constitutional assembly would only be a decision on the redistribution of political power. This is not the only problem. In Professor Pajvančić's opinion, even if the idea of a constitutional assembly as the institution which should adopt a new constitution were accepted, numerous questions still remain unresolved – representation in a constitutional assembly, who would set the rules for the election of the constitutional assembly, decision making in the constitutional assembly, etc.

Another alternative is constitutional revision in two phases with a duality of real and formal constitution-makers. This idea is presented by Nenad Dimitrijević, Professor of Constitutional Law at the Central European University, in the model of the Constitution of Serbia, prepared by the Forum Iuris.

The next alternative is a two-phase strategy of constitutional revision which implies consensus on the procedure and constitutional declaration, and the adoption of the Constitution. The first, i.e. previous phase of the constitutional process involves the preparation of content related and procedural principles of the future Constitution in several steps. The first step is the organization of a roundtable to initiate discussion on constitutional issues. The roundtable would have three main tasks: to constitute and establish working rules (a consensus on the rules on working procedure), to establish basic principles of the constitutional declaration and to define procedure for the adoption of the constitution. The

constitutional declaration is a kind of political document which contains basic constitutional principles and rules of constitutional procedure agreed consensually. Public debate on the principle of constitutional declaration would follow; this public debate would show readiness (or the lack of readiness) for acceptance of these principles as a fundament of the community. The second phase would take place in parliament according to the rules of the newly-established procedure of constitutional revision. The Parliament would adopt the Constitution according to the rules established in the declaration on constitutional principles.

Soft amendments to the Constitution (based on laws and on judicial interpretation of the Constitutional Court, e.g. in Hungary), as another alternative, are possible providing a consensus on basic guidelines and dynamics of societal changes. Professor Pajvančić thinks that we do not have such a consensus, and therefore this alternative was not an option.

The following alternative refers to gradual and partial changes of the constitution which develops in several stages. First, all confusing, contradictory and disputable provisions and solutions should be removed from the Constitution, especially those regulating human and property rights. The adoption of a declaration on human rights by the Parliament would be the second phase that could be implemented according to existing constitutional procedure (including a referendum) or exclusively in the Parliament.

This idea has certain advantages, because consensus is most likely to be reached in that area. It would permit for the adoption of standards on human rights and would be an important step toward the transition to a constitutional state and toward connecting with the world. Since it would not be difficult to reach consensus in this area, this option can be given an opportunity. The adoption of the constitutional declaration on human rights would mark the beginning of the process of constitutional changes, and would inspire debate on redefining other segments of the core of the constitution. Opting for this course would mean a compromise in relation to *continuity – discontinuity*.

In conclusion, Professor Pajvančić underlined two questions that arise out of the debate on constitutional issues so far, on which, in her opinion, discussion should be focused: firstly, the existing or alternative procedure on the revision of the constitution, and secondly, the constitutional assembly, the parliament in its current formation or some of the two-phase alternative procedures (constitutional committee).

Territorial Organization of Power

Ilija Vujačić, Professor at the Faculty of Political Science in Belgrade, discussed the problem of territorial organization of power which may appear as one of the most controversial questions of the new constitution, and on that may cause a constitutional blockade in terms of consensus. At the beginning, Professor Vujačić gave some important introductory remarks. The problem of territorial

organization of power should be approached with full consideration of the short period of time at our disposal for making a new constitution, but at the same time without allowing the speed of the process of resulting in negative consequences. Also, the transition from an authoritarian democratic system is closely related two issues: decentralization and regionalization, which should serve the purpose of liberalization. These processes must take place simultaneously, in order to prevent decentralization and regionalization from being comprehended as pure mechanisms of territorial reorganization of power, which may result in more serious problems than the present organization of power. Professor Vujačić stressed that territorial reorganization of power is a long and open process, while he advocates a pragmatic and open approach to this issue through small and cautious steps. Such a position was confirmed in the experience of Germany and Italy after the 2nd World War, and of Spain after 1979, as well as in the process of decentralization and reorganization carried out in East European countries which took almost a decade.

Professor Vujačić gave a few suggestions on the principles of how this problem should be approached in order to reach constitutional consensus.

Firstly, it is necessary to establish a dispositive principle which would allow for the possibility for different levels of autonomy to be introduced according to wishes and possibilities, i.e. capacities for the realization of autonomy. Secondly, a constitutional solution should be open, leaving the system to define itself following its development in the upcoming years.

Hence, it is important not to impose one definite structure, but only to ensure a constitutional framework in which autonomy can be established. The basic form of regional autonomy can be constitutionally regulated by establishing a maximum amount of prerogatives and minimal content which the central regions could have. Professor Vujačić refers to a kind of asymmetrical regionalization which should be given advantage over any kind of uniformity and symmetry.

When such a constitutional possibility is established, municipal assemblies, desiring to set up a region, appear as initiators of the introduction of the regional autonomy, and with regard to their own capacities, they define the level of prerogatives and self-governance they will take over within the future region. However, this openness should be limited by a certain number of constitutional provisions which regulate the procedure of achieving regional autonomy and residual consensus with central power.

It would be wise to define a trial period during which municipalities would be allowed to test their wishes and possibilities, i.e. to adjust their capacities to prerogatives they plan to take over.

All of these, in Professor Vujačić's opinion, entail respect for four basic principles: the principle of democracy of wide participation; the principle of subsidiarity, i.e. what can be done by lower and narrower communities should not be carried out by higher authorities, with the result that decisions are made in places where their effects are most directly felt; the principle of economic rationality, namely, individual responsibility for one's own position, which shall force everyone who

wishes a high level of prerogatives to take into careful consideration whether the prerogatives in question will bring about benefits or losses; the principle of liberalism, i.e. less of the state and reduced state regulation.

In conclusion, Professor Vujačić pointed to possible problems that may result out of haste and hurry, which is, in his opinion, being forced on us.

If we accept quick, mechanical solutions, the territorial organization of power may become a serious problem, because it will turn out that at many levels, where we would eventually foresee regions to be established, there is insufficient political and administrative skill, unwillingness and lack of readiness for taking over regional prerogatives. This may result in growth of irresponsible democracy, waste of resources and non-accomplishment of projected results, compromising of the concept of decentralization and regionalization, and fragmentation and decomposition, i.e. weakening of the state union by transforming regions into small principalities, which is dangerous in the long run.

Professor Vujačić pointed to economic problems of the territorial organization of power, meaning that multiplication of state regulations and control (as both central power and territorial communities are established as new regulatory agencies) are the most probable results of a thorough regionalization and decentralization which is not governed by liberal insights. This is especially notable in those proposals which stress the concept of a social market economy or a social welfare state based on a market economy. However, we need a constitution that is neutral in terms of ideology, and it can be established, at least with regard to its economic section and economic categories, in a very simple way. It is not necessary even to mention a market economy, but to incorporate two short and simple, but at the same time apparent economic principles: sanctity of property and the guaranteed freedom to make contracts, Professor Vujačić concluded.

Debate on Open Constitutional Issues

Vojislav Stanovčić, academician, described the present situation in the country not as a crisis, but as confusion, as anomy, i.e. a situation in which neither legal nor moral norms are observed, enforced and obeyed, and as total uncertainty. This is uncertainty with regard to the state, its borders, its population, with sovereignty being an issue that is not even worth addressing.

The tradition of not observing laws in our country tells a lot about the predominance of political will over legal rationality. Mr. Stanovčić is afraid that a similar destiny awaits the new Serbian constitution.

In Mr. Stanovčić's opinion, the first question relates to the way the constitution is adopted: how to adopt the new constitution in a relatively short time, but at the same time how to ensure its legitimacy and make it binding.

Although Mr. Stanovčić agrees that the Constitution should have been amended immediately after political changes took place because of the 2/3 majority that existed then, he still advocates an election for a constitutional assembly to be

called. After adopting the Constitution, a constitutional assembly could be transformed into a national assembly, thus getting necessary legitimacy, while citizens will be given the possibility to express their political will. Mr. Stanovčić also believes that "good is better than fast", although he agrees that the constitution can be adopted in a very short period if there is consensus.

Mr. Stanovčić stressed that it is very important to ensure division of power. There is no Constitution without division of power. A constitution serves to limit power and to submit it to certain rules. Division of power is very important, and therefore, in Mr. Stanovčić's opinion, we need a strong president and a strong government. We need a strong government to pull us out, given our current state of affairs, but we also need a strong president to discipline the parliament and all the others, using suspensive veto and not allowing just any laws to be enacted.

However, a strong government does not depend only on prerogatives granted to it, but also on the character of the election system. Mr. Stanovčić explained that the proportional system is more convenient for our country, as a very complex, multinational community. The proportional system enables larger numbers of small parties to have their representatives in parliament. However, in such a system it is hard to sustain coalitions, and governments are weak. Hence, we should seriously take into consideration the choice of principles of an election system. The majority system does not favor that many parties. Small parties and representatives of minorities will certainly oppose such a proposal, but Mr. Stanovčić stressed that minorities are the first to suffer because of unstable governments, and it is better for them to have a solid system, and to realize their minority rights through other instruments. A strong and stable government can be achieved through the majority system, which is confirmed by the experience of France and Italy.

Mr. Stanovčić believes that the state should be defined as a democratic and civic national state, incorporating the rule of law, because, democracy without the rule of law is a tyranny by a majority. However, if agreement cannot be reached on whether our country should be defined as a multicultural state or a state of the Serbian people, Mr. Stanovčić believes that it is not necessary to create conflict over an issue no one can benefit from. Without consensus, the definition itself does not matter; besides, why make any definitions at all, if we might have to make a new constitution in three years.

In conclusion, Mr. Stanovčić highlighted the issues of the referendum, human and minority rights, pointing out the problem of their realization and stressing that constitutions must postulate free mandates to deputies.

Radoslav Stojanović, Professor at the Faculty of Law in Belgrade, also discussed open constitutional issues, putting special emphasis on the issue of accountability.

Professor Stojanovic stressed that every constitution can be made only provided that the philosophical and theoretical foundations for it are established. He mentioned the widely praised Constitution of Serbia from 1888. Its chief author,

Milovan Milovanović based this Constitution on biological (organic) theory. This is, in Professor Stojanović's opinion, an absolutely perfect concept which captured a very important institution in the constitution, i.e. accountability. Today a lot is being said about rationalism, prerogatives, etc. but each prerogative at the same time entails accountability.

The shortcoming of organic theory, which did not exist at the time when it was created, but today is very important, refers to decentralization. Professor Stojanović stressed that horizontal decentralization has been mostly discussed, i.e. a type of territorial decentralization, which concerns regions, municipalities, districts, but vertical decentralization has not been addressed at all. We need to shift from biological-organic theory toward modern systemic theory. Carl Deuthch's cybernetic model is based on the principle of so-called soft hierarchy. The principle of hierarchy must be present in the organization of a state. We should not discuss whether the government should be strong or weak, but how it is going to function. In his opinion, the government will function well if we introduce the principle of soft hierarchy. This means that government, i.e. each of its portfolios, has a certain part of sovereign prerogatives.

If we do not define the organization of the government, debates on the choice between a weak and a strong government are futile. Namely, if we do not apply this principle, we may arrive at a situation where we have a strong president instead of a strong government, because the principle of systemic theory is accountability. Accountability must be organized in a top-down manner, but also bottom-up (feedback reaction). Without vertical decentralization we will certainly not have a good government, regardless of it being strong or weak, Professor Stojanović concluded.

Desimir Tošić, Vice President of the Democratic Center gave several political suggestions, i.e. observations. Speaking about the time we have at our disposal for the adoption of the new constitution, Mr. Tošić stressed that it is most important to adopt a quality constitution based on a wide consensus, and not to pay so much attention to the time available.

As far as regionalization is concerned, in Mr. Tošić's opinion, we must be aware of two risks. On the one hand, regionalization tends towards the federalization of Serbia, but on the other, there is a risk that putting emphasis on regionalization might be an attempt to eliminate the autonomy of Vojvodina by dividing it into three large parts, which would be our great weakness. The issue of regionalization raises many other questions. Mr. Tošić agrees that it should be asymmetric. However, citizens' approval is also necessary before establishing regions, namely, regionalization cannot be imposed by force. Moreover, there is the question of financial capacities, since regionalization can be very costly. Another risk refers to the possible increase in administration, i.e. red tape. Hence, special attention should be paid to our capability to carry out regionalization. This means that the Constitution should not contain any imposed principle, but must allow for organizational possibilities, regardless of the problem of asymmetry.

Ownership is in Mr. Tošić's opinion a special issue. The transfer from the psychosis of collective ownership into the psychosis of total privatization, i.e. total neo-liberalism is very dangerous. We are one bare, worn out, impoverished country which still has very strong awareness of collective ownership, even today. Hence, besides giving priority to private ownership, other modalities of ownership must be considered also, along with the social character of the state. At this moment we need a social state, and we will continue to need it for some time in the future, Mr. Tošić concluded.

Predrag M. Vuletić, President of the Liberal Democratic Party discussed the incorporation of constitutional principles into the future Constitution.

Speaking of our constitutional experiences from the past, Mr. Vuletić stressed that today, as was the case in the past, there are some political options which have become unlimited in their power. Their power should be limited by incorporating certain principles into the Constitution.

A fundamental, democratic principle, which is everlasting and proven through time, is the principle of sovereignty. Another principle is the principle of accountable and replaceable governments. This principle means that the citizens' will is a source of power and elected representatives are accountable to it. Mr. Vuletić suggests that this principle should be defined as a constitutional principle of popular sovereignty. The principle of accountable and replaceable governments entails the limitation of power, division of power into legislative, judicial and executive, but at the same time, the incorporation into the constitution of mechanisms for testing governments elected in this way, e.g. the institution of testing the legitimacy of the government through parliamentary procedure.

The third principle is the principle of care for minorities. This care should therefore be defined as a constitutional category, but it should be limited, too, in such a way that it cannot be enforced to the detriment of the majority.

The concept of regionalization must be closely related to the experiences of European countries. Namely, they resolved the problem of possible federalization through bicameral parliaments. Election for one chamber is organized under one election system, and for the other chamber, under another system, with administrative units not coinciding with electoral units.

Mr. Vuletić advocates that Serbia should be organized as a parliamentary monarchy with a king as institution in the tradition of democratic states of Europe.

Dragan Bataveljić, Professor at the Faculty of Law in Kragujevac discussed several basic principles that should be incorporated into the new Constitution.

In Professor's Bataveljić's opinion, this primarily concerns the division of power into legislative, judicial and executive, and a proportional election system. The procedure for adopting the new Constitution and for constitutional revision should include a public debate and a 2/3 majority in Parliament; also, decentralization should be carried out, while the President of the Republic should be elected directly in order to have democratic legitimacy. We need both a

strong President and a strong Government, i.e. twofold executive power. It is also necessary to establish constitutional appeal for popular sovereignty and accountable and easily replaceable governments.

An independent judiciary is of great importance; this can be realized in several ways, primarily through election. The High Judiciary Council should be responsible for proposing judges, and the National Assembly for appointing them.

Another significant institution that should be introduced is the ombudsman for human and minority rights, and respect for European standards, so as not to be in a situation of having to change in a very short period what we have adopted.

In conclusion, Professor Bataveljić stressed that our Diaspora is very strong and active, and willing to help; they should be enabled to purchase state-owned and socially-owned enterprises instead of foreigners.

Zoran Lončar, Professor at the Law Faculty in Novi Sad discussed the position of the President of the Republic in the new Constitution of Serbia. As far as the dilemma between a strong or a weak president is concerned, it is not visible in any of the four existing concepts of the new Serbian Constitution, since none of them foresee a strong President of the Republic. None of the projects advocates essential prerogatives which make the president strong, i.e. powers related to the state of emergency, war, etc. In Professor Lončar's opinion, this concerns a false, artificial dilemma which conceals what is fundamental here, i.e. the manner for electing the president. A strong president is identified with direct elections. Professor Lončar stressed that what Serbia needs today, given the very poor democratic tradition and very low political culture, is direct election of the president. In that sense, indirect election might result in cohabitation of power in certain moments. Professor Lončar sees no reason for fear of such a political situation in our country; moreover, it would be beneficial for the stability of the political system and the establishment of a democratic tradition of governance in our country. Another thing that speaks in favor of direct election of the President of the Republic is that all four concepts of the Constitution advocate a certain level of regionalization of the state. Again, regionalization in itself is a potential danger for the unity of the nation. Direct election of the President of the Republic is a safeguard of political unity of the nation.

Professor Lončar discussed the problem of respecting constitutional rights and freedoms. Our problem does not lie in the normative enactment of constitutional freedoms and rights, but in the respect for these rights in practice. Hence, Professor Lončar advocates and supports the institution of constitutional appeal. Although it is rarely applied in practice, it should exist as it is an ultimate form of legal protection. Also, he advocates another institution which protects citizens' freedoms and rights, i.e. the ombudsman. This is what we certainly need, Professor Lončar concluded.

The Constitution and Efficiency of State Administration

Dragoljub Kavran, President of the Committee for State Administration, stressed that the issue of the adoption of the Constitution is of key importance for every country, but we should not put too much hope in adopting a perfect legal document that is comprehensive and that will be able to resolve all questions in decades to come. We can probably adopt an act which will be a compromise with regard to the situation we have today, simply because everything else would be a triumph of hope over experience, as was proven in recent practice.

Mr. Kavran warned that we must be realistic, i.e. we must not waste time and energy on the procedure, instead of resolving essential issues. One of the key conditions for adopting the Constitution is the ambient in which the Constitution is due to be adopted. The ambient in which we are creating the constitution and in which we are organizing our state, the position and role of the state administration, is not only determined by internal dynamics, but also by the dynamics of external influences, and this is not as irrelevant as it seems. Also, one of the key issues is the issue of the capacity of legitimacy. We need a broad consensus which would bring capacity of legitimacy to what is being done now. If an agreement is not reached on a wide range of issues, the state will constantly slouch and totter. It will totter especially because it is burdened by deadlines (three years), as well as because of the impact of various international actors, whereby we should keep in mind that everything we do will be subjected to a thorough optical assessment by international community in terms of to what extent it conforms to European standards.

Mr. Kavran also discussed the work and reform of the state administration. In his opinion, "the fatigue of reform" has begun too early. We have started keeping rhetoric contents of reform, while changing very little in practice. When reform of the state administration started, there was a consensus on some basic principles: depolitization, professionalism and transparency. Mr. Kavran especially pointed to the problem of corruption, which, again, is escaping attention, especially in the economy, although the state at one moment made a good start toward the control of corruption.

Furthermore, there is the problem of regulation and deregulation. Instead of being a citizens' service, which was its initial objective, the state administration is pursuing even more control than before: there are hundreds of "check points", inspections, etc. which are piling up in order to put under control other activities. Mr. Kavran does not agree with such a course. Finally, he believes that centripetal pressure of the EU in our country should be used for the reform of the state administration, since two systemic laws, i.e. the Law on State Administration and the Law on Public Servants have not been enacted yet. Without these systemic laws, we can not change the character of the state administration because present laws are too rigid and do not allow flexible administration which should serve the economy and citizens, and not vice versa.

The entire area has to be regulated, and, to become clear and transparent; otherwise, constant conflicts will lead to a completely non-transparent situation in a political sense, Mr. Kavran concluded.

Similarities in the Processes of Adopting the Constitution in Croatia and Serbia

Zoran Oklopčić, Assistant at the Law Faculty in Zagreb, Croatia, stressed that the constitutional processes in Serbia and Croatia are too different, not allowing any substantial conclusions to be drawn from comparative analysis. Mr. Oklopčić found certain similarities in the debates on the organization of power, on the position of the President of the Republic and on the type of discourse in constitutional debates in Croatia and Serbia.

Mr. Oklopčić stressed that there are three ways to discuss the constitution: a principled discussion, bargaining and strategic use of allegedly principled arguments.

In his opinion, a principled discussion is confined to the margins of political life, i.e. to the scientific community. Bargaining is not that markedly present, at least not in Croatia, as seems to be the case with Serbia, as well. Namely, the governing elite has reduced the need for bargaining. What is left is strategic use of allegedly principled arguments, which may be useful and which are actually an indicator of the civilized role of hypocrisy. Mr. Oklopčić believes that the scientific community should move hypocritical discourse, in a neutral sense, toward what is principled.

As far as the position of the President of the Republic is concerned, Mr. Oklopčić wondered what the Constitution serves for. The institutions established by the Constitution should prevent or to some extent disable haste in political decision-making. They should help the battle against corruption; they should help in "limiting political stupidity". For that purpose there is a suspensive veto, and bicameralism, even in unitary states. Understood in this way, the role of the president can be outlined not only as arbiter, but also an intelligent brakeman, Mr. Oklopčić pointed out.

Mr. Oklopčić discussed the issue of the constitutional court, i.e. its role with regard to constitutional appeals, to the principle of proportionality and to the issue of legitimacy of the Constitution, i.e. legitimacy of the state. As far as the last issue is concerned, Mr. Oklopčić stressed that the situation in Serbia is much harder than in Croatia, because the Constitution in Serbia should not only constitute authority, but it should also reconstruct the state as such. This is a *pactum unionis* of this state, Mr. Oklopčić concluded.

The New Constitution of Serbia – Constitutional Dilemmas

Aleksandar Simić, Judge in the Federal Constitutional Court discussed constitutional dilemmas. In his opinion, this is not a good year for Serbia to get a

new Constitution, and the Constitution will not resolve all the problems, especially the crisis of legitimacy that all of us suffer.

Mr. Simić focused on the problems of not respecting the previous Constitution, not only during the Milošević regime. He wondered if the reason for this is that the Constitution was “marked” by Milošević, and is hence bad, negative, authoritarian, or whether something else is at issue, i.e. the relatively long period of inability among political elites in our country in keeping to legal norms, and acting in accordance with the Law. Mr. Simić also pointed out a range of examples of violation of the Constitution since October 2000.

Keeping in mind everything previously advanced, Mr. Simić is not an optimist that the new Constitution, however good it may be, will be efficient. Violation of the Constitution in our country is a tradition.

However, reality and pragmatism require one fundamental act that will be respected. The previous one is obviously not being respected, not only because the main actors do not respect it, but because it lost its historical legitimacy (Kosovo and Metohija are no longer an integral part of Serbia, we do not have a President of the Republic, etc.). Therefore Mr. Simić believes that it is necessary to have far more pragmatic talks on constitutional changes, without great themes being directed toward the expectation that the new Constitution will reconstruct the union, restore damaged legitimacy of the community, establish lost identity of people and citizens, etc.

Main Principles of the new Constitution of Serbia – the Model Proposed by the Democratic Party

Zoran Lutovac, from the Institute of Social Sciences discussed the main principles of the new constitution of Serbia. At the beginning, he presented the model of the future constitution of Serbia proposed by the Democratic Party: a model of rational parliamentarism with a president who is elected in Parliament and who has representative prerogatives in the tradition of usual standards of the parliamentary system; a decentralized Serbia based on functional and asymmetric decentralization with special emphasis on local self-governance, and a unicameral parliament. As far as the legitimacy base is concerned, Mr. Lutovac believes that there is no dilemma in that respect, it being a democratic civil principle, which at the same time defines the carrier of sovereignty.

Human rights would be defined in accordance with international standards, as well as our local standards, which, in Mr. Lutovac’s opinion, sometimes go beyond European standards. Where our standards are higher than the European, they should not be lowered, but preserved and improved.

The structure of power would be defined as rational parliamentarism, whereby the President of the future state may, but need not have a balancing role. The president may have a balancing role when the government comes from one party and the president from another. But, if the government and the president

are from the same party, that balance does not exist in a political sense, Mr. Lutovac stressed.

Conflicts are essentially focused on the issue of the method of electing a president, and not on whether the president should be weak or strong. However, Mr. Lutovac stressed that it is not logical to have a directly elected president with weak prerogatives, and therefore, if the president is elected directly, he should have wider powers. It is of key importance to make decisions which relate to Serbia in several years, and not to Serbia of today, because this is the perspective from which we should start moving toward the creation of an institution of the president with a representative role in the political system. Also, it is possible for the president to represent all citizens and to personify state unity, even if he is elected in the Parliament.

The Parliament should be unicameral. Again, bearing in mind Serbia the way it is, and the way it should be in the future, and in view of the principles of efficiency and functionality, in Mr. Lutovac's opinion, legislative procedure in a bicameral parliament would be very slow and complex.

As far as the government is concerned, the Constitution would define efficient mechanisms of parliamentary control of the Government, and, on the other hand, it would guarantee the Government great powers.

Mr. Lutovac stressed that decentralization is primarily based on strong local self-governance which would have wide electoral power and strong financial autonomy. On the other hand, the state, according to the law, assigns municipalities, provinces and regions the pursuance of certain administrative functions, while maintaining administrative and other supervision, Mr. Lutovac concluded.

Budget of the Judiciary and Constitutional Appeal

Bozo Prelević, from LEX, discussed the budget of the judiciary and constitutional appeal.

In Mr. Prelević's opinion, the declaration of independence of courts often did not contain instruments to implement that independence in practice, and an independent judicial budget is one of prerequisites for the independence of courts, together with the procedure of election and dismissal of judges which is similar in all four offered models of the Constitution.

Mr. Prelević also discussed the issue of constitutional appeal, which he has recently started to advocate for several reasons, one of which is particularly practical. After our entry into the Council of Europe and after the adoption of the Charter on Human Rights, in Mr. Prelević's opinion, it is more practical for Serbia to have constitutional appeal with regard to these issues which could be raised before the Court in Strasbourg, as well. The State cannot address that court if it does not previously exhaust all domestic instruments. Mr. Prelević also stressed that this is a filter that would prove very good and very practical, and, on the

other hand, would be accepted by courts in the domicile country when their own court points to the violation of human rights.

Conclusion

In conclusion ***Miroljub Labus***, Professor at the Law Faculty in Belgrade summarized the work of the roundtable.

Firstly, with regard to the time, Professor Labus stressed that we do not have any time to waste, more for pragmatic than for constitutional and legal reasons. Without a Constitution and the founding of certain institutions, there will be no investments and economic recovery. Constitutional uncertainty results in political, i.e. economic uncertainty, which is a huge risk for investments. Hence, what is important are institutions and the removal of constitutional uncertainty.

Secondly, with regard to open constitutional issues, out of eleven open issues, only a few have actually attracted attention, implying that there are far fewer open issues than we think. Again, this means that there is much more chance for an open compromise and agreement than it seems.

Finally, Professor Labus expressed his concern that a negative atmosphere for a change of the constitution has been made. We need a positive atmosphere because the Constitution is an extremely important act in the life of a nation. We do not need a negative atmosphere to cause even more problems than we have today. Professor Labus hopes for a more positive atmosphere in which disputed issues can be resolved, especially if we keep in mind Serbia in 2008, and not Serbia in 2003.

Editor	Ph.D. Mirosinka Dinkic
Prices	Kosovka Ognjenovic, M.S.
Wages and pensions	Jelena Momcilovic Iva Jovanovic
Labor market	Jelena Momcilovic
Industrial Production	Aleksa Nenadovic
Foreign trade	Aleksandra Brankovic
Monetary and Fiscal Policy	Kristian Vukojicic

Macroeconomic Review

SLUMP IN PRODUCTION AND RISE IN FOREIGN TRADE

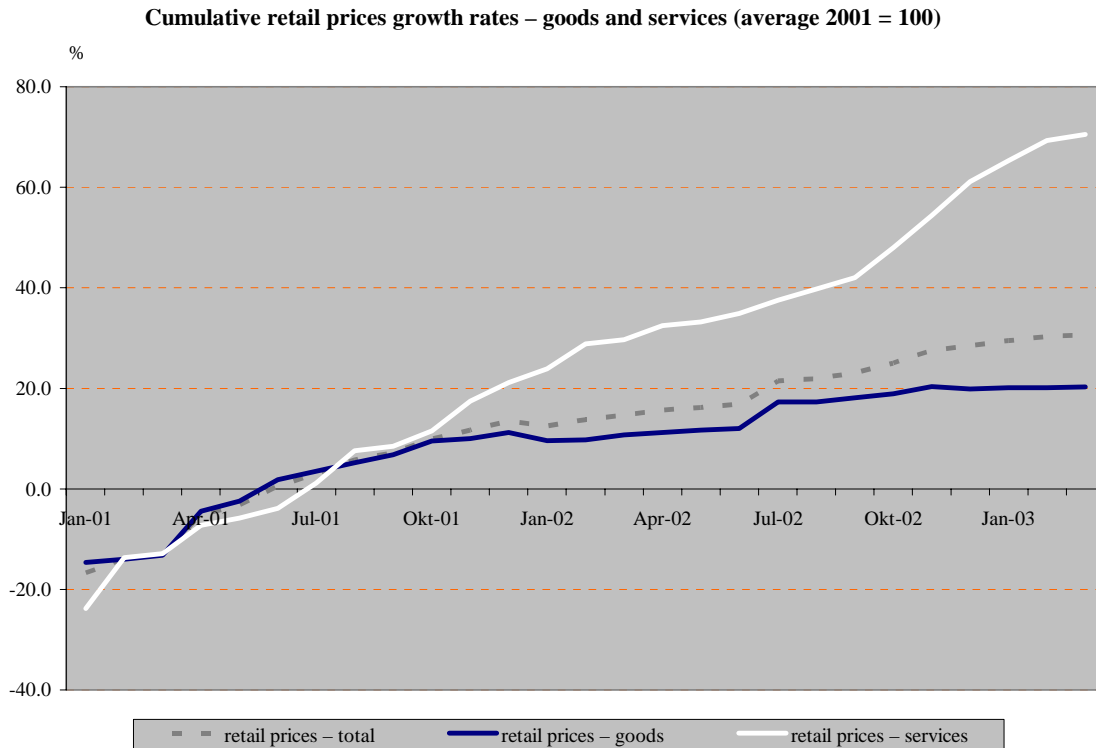
Prices

Inflation in the first quarter of 2003 was 1.8%. If such a trend continues in the coming months, retail price inflation at the year-end will reach 7.4%. The liberalization of prices in the sector of goods (excluding electricity) has had positive effects, as these prices are formed according to market principles. (see Chart).

The measured inflation rate was primarily generated by the increase in the price of services. The level of prices of services at the beginning of 2001 was considerably lower than of the prices of goods, having resulted from a long period of control of growth in the price of services in the public sector. The policy of price liberalization in the sector of goods affected trends in these prices. As can be seen on the Chart, the prices of services cumulated considerable growth since September 2002, while the prices of goods were in stagnation. Since the beginning of 2001, until March 2003, the price of services grew 3.5 times faster on average than the prices of goods.

Inflation trends in the first quarter of 2003 are similar to last year's. The dynamics of retail price inflation in the first half of 2002 resulted from a rise in the prices of services (these prices grew every month) and the prices of agricultural products (largely due to seasonal oscillations in the supply and demand of fresh fruits and vegetables). Similar dynamics of retail prices are likely in the several coming months. Such expectations do not involve the

announcement of increase in the price of electricity, which would affect to a certain degree the increase in the cost of production of industrial products.



In 2002, industrial producer prices increased by 8.8% on average year-to-year. With regard to the destination of consumption of industrial products, consumer goods cumulated the largest increase; the prices of intermediate goods grew much slower, while capital goods almost stagnated. Last year's trends in the three sectors of industry were the following: prices in the sector of energy, gas and water supply increased by 69.3%, prices in the manufacturing sector were up by as little as 3.2% on average, while the prices in the sector of mining and quarrying were down by 0.2% compared to the average prices in 2001. In January 2003, prices in the industry rose by 0.2%, relative to December 2002, due to the increase in labor costs in the sector of mining and quarrying and due to the higher price of inputs in the sector of metals and metal processing. Industrial producer prices in February 2003 were in stagnation.

The value of authorized purchase of agricultural products from individual farms and agricultural enterprises in 2002 was nominally down by 8.3% year-to-year. Agricultural producer prices increased by as little as 1.1% in 2002. Besides

administrative benefits, a slower growth rate of the price of food products during 2002 resulted from the low price of inputs in the food processing industry. Since the beginning of this year, consumer prices have grown at a slower pace than retail prices. Compared to December 2002, the cumulative growth of consumer prices in the first quarter of 2003 amounted to 1.2%. While the average price of food remained unchanged since the beginning of the year and the growth rate in the price of clothes and footwear averaged 0.2%, while housing costs rose by 2.9%. Higher housing costs resulted from growth in the price of public utilities in February (due to an increase in the prices of water and of garbage collection), as they are still under administrative control.

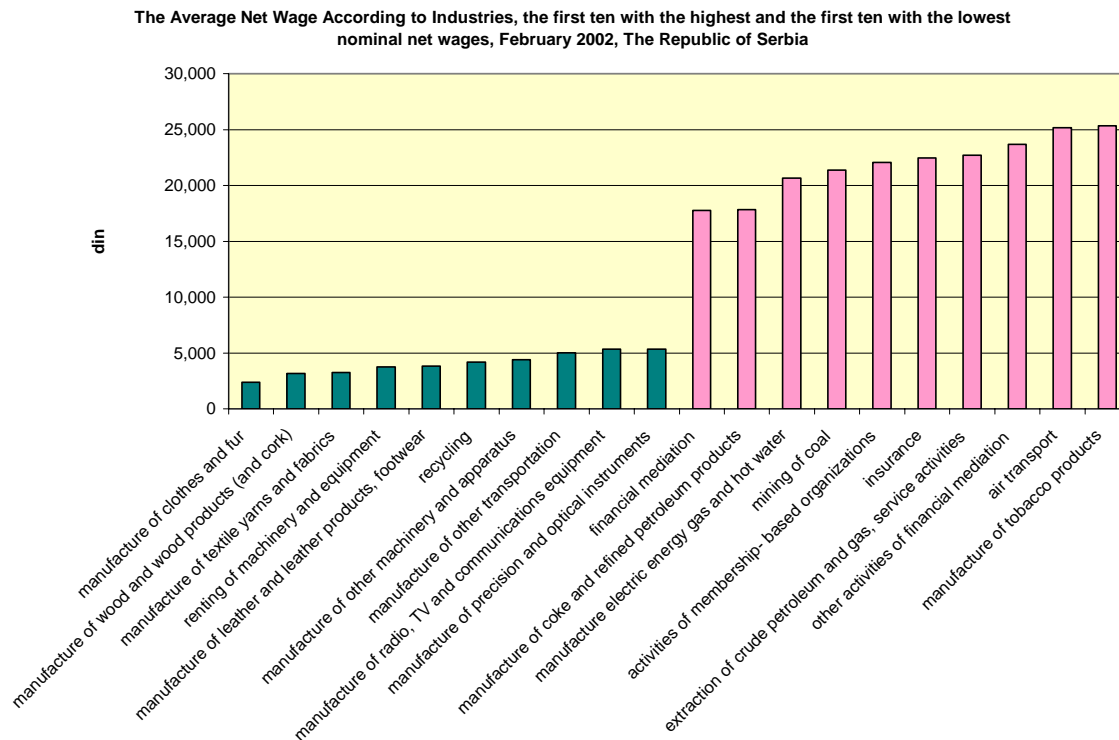
Wages and Pensions

The average net wages registered a sharp drop both in nominal and real terms in the first two months of this year, compared to the end of 2002. However, year-to-year, the average net wage was nominally up by 29.1%, i.e. by 14.8% in real terms. This implies that the living standard of the employed has been sustained at a relatively high level that was achieved during the last two years.

An 18.1% drop in the average nominal net wage in January month-on-month brought the average net wage back to the level of July 2002. Coupled with a 0.4% growth of CPI, the average net wage in January was down by 18.4% in real terms relative to the previous month.

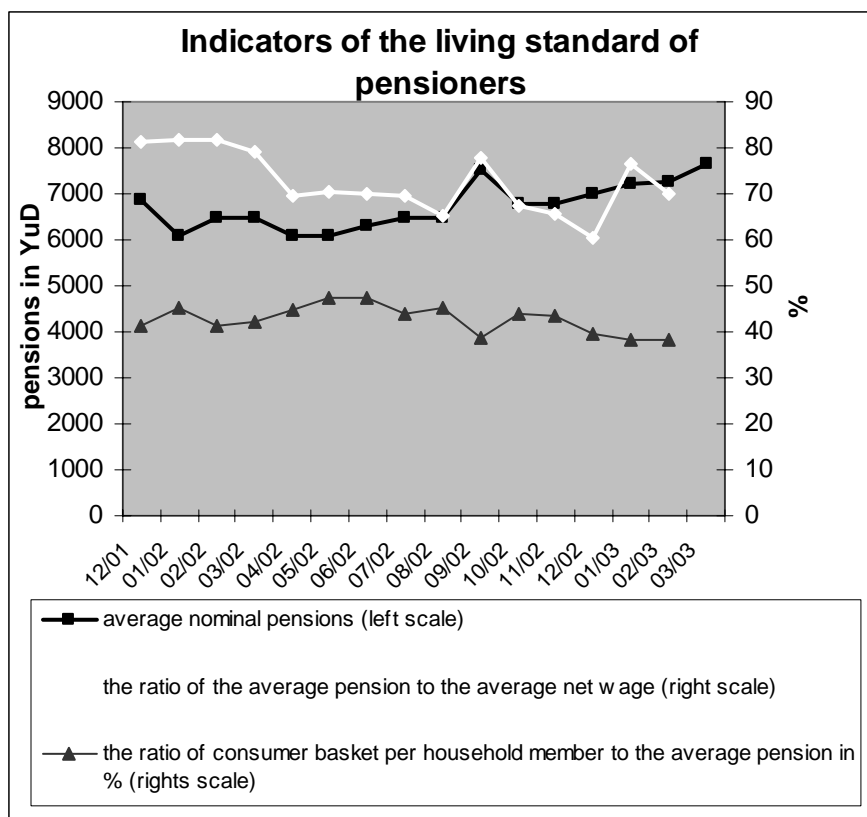
According to the analysis, such a sharp drop in the average net wage, besides long holidays in January, resulted from the fact that a great number of employed persons did not receive their wages. According to the data of the Statistics Bureau of the Republic of Serbia, the portion of those who were not paid out their wages in December in the total number of the employed in the socially-owned sector (together with companies in mixed ownership and cooperatives) constituted 12.4%, but in January, this portion increased to 18.2%.

In February 2003, the average nominal net wage in Serbia increased by 9.5% month-to-month, amounting to YuD 10,367; in real terms, this was an 8.8% increase. However, this increase was not sufficient to compensate for the sharp drop in January, and hence, the average net wage in February 2003, compared with December 2002, was down by 10.3% nominally, or by 11.2% in real terms. The ratio of the value of the consumer basket to the nominal net wage increased to 1.2 wages for one consumer's basket; in December 2002, the value of the consumer basket was equal to the nominal net wage, while in February, this ratio registered month-on-month improvement, being 1.1.



In February, the nominal net wage in the economy averaged YuD 9,525, while the average nominal net wage in the non-economic sector was slightly higher, amounting to YuD 12,853.

Huge differences in average nominal net wages resulted from unequal distribution of redundant workers among industries. Thus, both in January and February 2003, the lowest nominal net wages were registered in the manufacture of clothes and fur (YuD 1,833, i.e. YuD 2,376), while the highest wages were paid out in the insurance industry (YuD 25,350), which means that the highest average net wages are 11 times higher than the lowest average nominal net wages (see the Chart).



The average pension paid out by The Old Age Pension and Disability Fund of the Employed in January 2003 was YuD 7,237, comprising the second portion of the October pension and the first portion of the November 2002 pension. It was nominally up by 3.3% compared to the pension paid out in December 2002, or by 2.9% in real terms. The second installment of "the great debt" in the amount of YuD 392 was paid out in January to 657,297 pensioners.

The pension paid out in February averaged to YuD 7,245, and comprised the second portion of the November pension and the first portion of the December pension. This pension remained nominally at the level of the one paid out in January, but in real terms it was down by 0.5%. During this month, the third installment of the debt toward pensioners in the amount of YuD 392 was paid out to 660,949 beneficiaries.

The average pension paid out in March amounted YuD 7,656, comprising the second portion of pension for December 2002 and the first portion of the January pension. It was nominally up by 5.7% month-on-month, or by 5.4% in real terms. In March, the fourth installment of the debt toward pensioners in the amount of YuD 435 was paid out to 665,357 beneficiaries.

Owing in part to the decrease in the value of the statistical consumer basket per household member and in part to the nominal increase in pensions, 39% of the average pension was sufficient for the purchase of items comprised in the consumer basket during several previous months, and measured by this indicator, the living standard of pensioners has recorded growth. However, it

should be borne in mind that the amounts paid out on the basis of repayment of "the great debt" were not taken into consideration in the calculation of this indicator.

Labor Market

According to the data of the Labor Market Bureau of the Republic of Serbia, the unemployment at the end of February amounted to 938,190 persons, which is up by 1.6% month-on-month, or by 17.9% compared to the same month last year. The registered unemployment rate in February was 31.64%, an increase of 3.9 percentage points year-to-year. Employment in the socially-owned sector continued to decrease (a drop of 7.3% in February 2003 year-to-year), while total employment, including workers employed in the private sector and small-sized enterprises, dropped by 2.3% over the same period.

The demand for labor in the period January – February 2003 was lower by 5.8% compared to the same period last year, while the number of terminations increased by 0.7% over the same period. The structure of initiated jobs indicates lower rigidity on the labor market. Fluctuation (direct transfer from one job to another) in Serbia in the first two months of 2003 averaged 43.46% of the total new jobs, while the remainder of new jobs refer to the formerly unemployed persons who were registered at the Labor Market Bureau. Such a situation implies significantly reduced rigidity, bearing in mind the fluctuation of 33.06% one year earlier. The difference between registered demand for labor and the number of employed workers at the beginning of 2003 resulted from the unadjusted qualification structure between supply and demand for labor; hence, the extent of the demand filled during that period was 81.52%.

According to the latest available data for December 2002, 83,952 persons were receiving unemployment benefits, a 56% increase year-to-year. The average number of unemployment benefits recipients in 2002 was up by 36% relative to 2001. Over the same period, the number of unemployment benefit recipients on the basis of redundant labor increased by 37% and on the basis of bankruptcy by 51.4%.

Industrial Production

The drop in industrial production at the beginning of 2003 is mostly seasonal. Industrial production in Serbia decreased by 3.8% (by 4.2% in Central Serbia and by 2.9% in Vojvodina) in the first two months of 2003 year-to-year. Namely, a relatively high month-on-month increase in industrial production registered in February (9.9%) in its significant portion amortized the sharp drop in industrial production registered in January, relative to December (by as much as 20.9%). With regard to the sectors, a sharp year-to-year drop in the period January-February 2003 was registered in mining and quarrying (by 17.4%); a milder

decrease was recorded in manufacturing (5.8%), while the sector of electricity, gas and water supply increased by 4.5%. Industrial production decreased also with regard to the destination of consumption (capital goods by 21.3%, intermediate goods by 2.3% and consumer goods by 4.2%).



Foreign Trade

Both commodity exports and commodity imports increased over the first two months of 2003 year-to-year; exports rose by 39% and imports by 14% (in nominal US\$).

According to preliminary data, Serbian trade with foreign countries in February was valued at US\$ 198 million, a nominal increase by 40% year-to-year. Commodity imports were valued at US\$ 442 million, nominally up by 17% relative to February 2002. In spite of the increase in commodity imports compared to last year, owing to more considerable exports growth, a trade deficit of a little over US\$ 500 million that was cumulated in the first two months remained at the level of the trade deficit registered in the period January-February 2002.

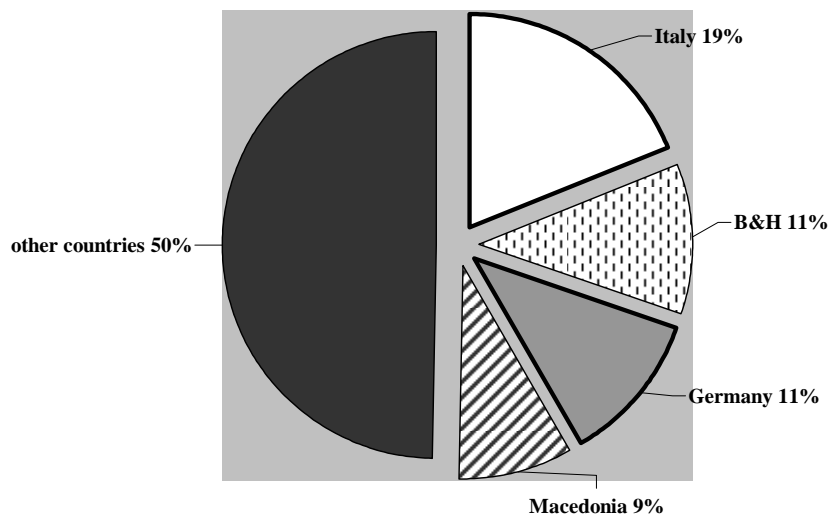
The analysis of foreign trade by regions shows that in the first two months of 2003, half of the value of commodity exports of Serbia was directed to the countries of the European Union. This market was dominant with regard to imports, as well; thus, 40% of the value of commodity imports came from the EU. The markets of transition countries of Central and Eastern Europe also had a

large share in Serbian foreign trade; these two markets account for 96% in the total exports of Serbia. Commodity exports to countries out of these two regions constitute as little as 4% of total exports.

On the other hand, as far as commodity imports are concerned, in the first two months of 2003 22% of imports derived from countries out of the EU and transition countries of Central and Eastern Europe.

The analysis of trade according to individual countries shows a very high degree of geographic concentration of Serbia's foreign trade. This problem is particularly present with regard to export, since one half of total Serbian commodity exports are sold to only four countries – i.e. Italy, Germany, Bosnia and Herzegovina and Macedonia, whereby commodity exports to Italy constitute as much as one-fifth. The situation with regard to imports is slightly better. Nearly 40% of total imports derive from three countries - i.e. Russia, Germany and Italy, which are followed by numerous other countries with relatively equalized and low participation in Serbian imports.

The most important markets for Serbian exports, January – February 2003



The structure of foreign trade with neighboring countries over the first two months of 2003 improved, compared with the same period last year. Not only that the surplus in trade with Macedonia and Bosnia and Herzegovina increased, but surplus was also registered in trade with Croatia, following considerable export growth and mild decrease in imports relative to last year. The deficit in trade with Romania and Bulgaria was also reduced significantly. Such a trend in case of Romania resulted from a huge increase in exports and in the case of Bulgaria from a year-to-year considerable reduction in imports. As far as Hungary and Slovenia are concerned, the trade deficit remained at last year's level. Both exports and imports with Hungary are in stagnation, where in case of Slovenia

exports increased considerably, but their value is still much lower than the value of imports from Slovenia.

Changes in the foreign currency exchange rate registered at the beginning of this year were more intensive than usual and resulted in nominal depreciation of the exchange rate of the Dinar against the Euro of 1.3% on average in February month-on-month. Since retail price inflation over the same period was 0.6%, a mild real depreciation of the exchange rate occurred.

Monetary and Fiscal Policy

Money supply at the end of March 2003 was YuD 107 billion, which was nominally down by 10% relative to January. Such a trend in the monetary area probably resulted from a considerable decrease in the level of economic activity at the beginning of this year.

Cash money supply in the total money supply has been gradually decreasing (from YuD 37.8 billion in January to YuD 35 billion in March) but is still very high, accounting for 32.6% at the end of March. In our assessment, more significant reduction of the share of cash money supply is likely only following the introduction of domestic bank cards.

The discount rate of the National Bank of Serbia in February and March remained at the level of 9% per a year. Interest rates on commercial and treasury bills and deposit certificates have been decreasing for three months. In January and February interest rate on the Belgrade Stock Exchange were 2.28% and 2.25%, being the lowest since 2000.

After a considerable drop of total public revenues collection to YuD 26.14 billion in January, collection increased by 60% in February month-on-month, reaching YuD 41.9 billion. Total public revenue collection in February registered growth of 16.8% year-to-year.

Similar trends were registered with regard to revenues of social insurance organizations. In January 2003 these revenues totaled YuD 7.9 billion and in February YuD 13.7 billion. Total revenues of social insurance organizations collected in February displayed a decrease of 3.5% year-to-year.

However, the structure of total public revenues in the first two months of 2003 changed considerably compared to the same period last year. The share of revenues of the budget increased from 61.5% to 68.3%, while the share of revenues of social insurance organizations decreased from 38.5% to 31.7%. The data on the drop in revenues of social insurance organizations appeared as worrisome, given the very high year-to-year increase in the nominal net wage realized in the period January-February.

The EU Review

Editor Tanja Mišćević
The EU News Ana Djorić, M.A.
Katarina Damnjanović, M.A.
Economic News Dejan Gajic

THE EU NEWS

Cooperation in the area of the Judiciary

The European Commission adopted two important documents in this area on February 18 and 19.

A co-operation agreement between the Commission and Europol was signed on February 18. The Treaty of the European Union (art. 29 and 30) mentions Europol as an important instrument of the Union's efforts in the prevention and battle against organized crime with a view to achieving the objective of providing its citizens with a high level of safety within an area of freedom, security and justice. The Amsterdam Treaty stipulates (art. 36) that the Commission shall be fully associated with work in the areas referred to in Title VI, i.e. police and judicial co-operation in criminal matters. The Europol Convention stipulates (art. 28/4) that the Commission shall be invited to attend meetings of the Management Board with non-voting status. The Commission also attends, since July 1999, meetings of the Heads of National Units of Europol, as well as various expert groups. For the Commission to be able to participate effectively in decision making in the Union regarding organized crime, it is essential that it has all relevant information at its disposal, including information from Europol. Since internal regulations of Europol foresee specific conditions for the transmission of confidential information to other organizations (including EU-related bodies) or third countries, a special agreement was necessary. This co-operation agreement had been negotiated by the Europol directorate and the Commission services, and it will allow only the exchange of strategic information, like situation reports and threat assessments, but it does not include the exchange of personal data. It consists of two parts, the first one describing the general framework for co-operation and the second one being an Annex, which specifies co-operation on the protection of the Euro against counterfeiting. The Directorate General of the Judiciary and the Interior shall act as a "contact point" of the Commission. In specific areas of co-operation which fall under the responsibility of Commission services other than JAI, direct contact between Europol and these services shall be possible. (This especially concerns services in charge of prevention of counterfeiting of the euro, fraud, corruption and money laundering which affect the Communities' financial interests).

On February 19, the Commission adopted a Green Paper on Procedural Safeguards for Suspects and defendants in Criminal Proceedings Throughout the

European Union. This Green Paper contains common minimum standards, but they can only be achieved if action is taken at the EU level, because if Member States retain discretion to set their own standards, discrepancies are inevitable. The aim is not to create new rights, but simply to make existing rights more visible and easier to implement. The outcome will in no case reduce the level of protection currently offered in the Member States. The starting point for the Green Paper was the European Convention on Human Rights supplemented by the case law of the European Court of Human Rights. Main sections set out the following areas where action is proposed immediately: access to legal representation, both before the trial and at trial; access to interpretation and translation; a guarantee that vulnerable suspects and defendants in particular are properly protected; consular assistance to foreign detainees notifying suspects and defendants of their rights. This Green Paper will be distributed to all interested parties, and the deadline for sending objections and opinions is May 15, 2003. Of particular interest will be the responses from defense lawyers who are confronted with practical problems of compliance with procedure.

Enlargement of the Union

On February 19, the Commission set the targets for recruitment of officials from the 10 new Member States from May 2004. This forms the latest stage in the Commission's ongoing and thorough preparations for enlargement. Recruitment targets are based on objective criteria so as to ensure a fair and transparent approach. Overall preparations have covered and continue to cover many different areas, including: a Commission staff policy which enables it to hire the necessary extra employees to cope with its increased responsibilities, whilst fully respecting the limits on Heading V of the Financial Perspectives (Administrative costs); re-organization of the linguistic services to ensure effective continuation of high quality multi-lingual services; and modernization of the Commission's systems to face increased workloads, in particular in terms of financial management. Vice-President for Administrative Reform, Neil Kinnock stressed that this enlargement increases the EU population by 20%, the number of Member States by 66%, and the number of working languages by 82%. The Commission's policy is to recruit officials on the broadest possible geographical basis among the nationals of Member States. In order to sustain that purpose and to use positive recruitment measures, the Commission is following the precedent of all previous enlargements and proposing to the Council a time-limited derogation (7 years) from the rule which forbids the reserving of posts for nationals of particular Member States. The Commission will set an overall recruitment target for new Member States, based on their relative weight in the enlarged EU and calculated on the basis of the three following objective criteria: the number of residents of each State, the weighting of votes for States in the Council, and the number of seats in the European Parliament for each State. According to this proposal, the absolute number of posts to be reserved for the

10 new Member States over the transition period amounts to 3441, of which, under the national breakdown, 10 are A1 posts, 42 are A2 posts and 189 are middle management posts.

On March 5, the Commission adopted its Annual Policy Strategy Decision for 2004, which sets out a clear political and resource framework for 2004 that will guide the preparation of the Preliminary Draft Budget and operational planning. The central political priority is the beginning of the enlarged Union's work. The two connected priorities are stability and sustainable growth. The Annual Policy Strategy is an innovation of the Commission's reform program. It is a part of the wider programming cycle which sets out political priorities, gives orientations on resource allocations for 2004 and provides the framework for the preparation of the 2004 preliminary draft budget for 25 Member States and the Commission's work program. For the central "accession" priority, additional financial resources are intended to finance the extension of existing programs to the enlarged Union. Funds are also intended to finance specific transitory measures under the internal policies decided at the Copenhagen European Council: the Schengen evaluation mechanism, support for nuclear safety in the new member states, and continued support to reinforce their administrative and institutional capacity. It will also mean increased funding for Turkey, Romania and Bulgaria over the period 2004-2006. With regard to "stability" the Commission proposed an additional allocation of € 175.0 million, which will improve border control and establish an integrated IT system on visa information, and develop a policy of security of communication networks. It also includes activities such as the fight against bio-terrorism. Stability outside the Union will be supported with an increase in support for the Western Balkans and the Mediterranean region, while at the same time enhancing the European initiative for democracy and human rights and providing more assistance through humanitarian aid to the regions in the world. Finally, as far as the "sustainable growth" priority is concerned, an additional € 45.7 million is intended to enhance capacity to respond to oil pollution disasters in the Union. This increase also covers implementation of the EU action plan on communicable diseases and financing of contributions to the Global Fund to Fight AIDS, Malaria and Tuberculosis. All in all, the 2004 budget in commitment appropriations could equal around € 111 000 million, of which, some € 11 000 million is dedicated to enlargement.

Gender Equality in the EU

The Conference on gender equality and Europe's future was held in Brussels on March 4. 60 university professors and European political leaders, among whom Ana Diamantopulu, member of the European Commission for Employment and Social Issues, Anna Karamanou, President of the European Parliament Committee on Women's Rights and Equal Opportunity, and Ms. Dean and Ms. Mendes de Vigo, members of the Convention, gathered to discuss different options for formulating special proposals on the position of women that will be

submitted to members of the Convention on the Future of Europe. An intensive debate between feminist lobbies, members of the European Parliament and members of the Convention on the Future of Europe on possibilities of improving attitudes to gender equality at the EU level that is underway is prompted by the prospects of adoption of the new EU Constitutional Treaty in the near future. In that respect, the European Commission wanted to organize a conference on this issue with professors who belong to the Jean-Monnet network. With assistance of the General Direction for education and culture of the European Commission, the network of professors and Jean-Monnet centers has established a tradition of consultancy with the academic world in recent years, with the purpose to exchange opinions on the future of European institutions. The Conference was organized in three sessions: the first session addressed the basic achievements of the EU as a promoter of gender equality in Europe. The main topics for discussion were gender equality, economic life and employment; equal pay for equal work; and a gender perspective on non-discrimination legislation and practice. The second session discussed new steps that should be made in the area of gender equality, in particular, policy making and policy instruments, addressing issues of gender equality and democratic participation and representation, gender mainstreaming and gender budgeting, and enforcement of dispositions on gender equality through legislation and practice. Finally, the third session addressed gender equality and the new EU, and especially the impact of enlargement of the Union and the Charter of Fundamental Rights of the EU.

At the same time, the Commission adopted the 7th annual report on equal opportunities in the EU, which presents the main achievements in gender equality in 2002. The report indicates that the EU has made progress in gender legislation, especially with adoption of the directive on harassment at work. The Report also examined Member States' new caselaw on equal pay and initiatives to reconcile work and family life. However, the Commission finds that data on women's participation in decision-making, especially in the private sector, are unsatisfactory. The report analyses how far gender issues have been given a role in each of the other EU policies ('gender mainstreaming') and how far candidate countries have progressed in adopting EU gender rules, concluding that 'paper law' is not, on its own, enough: there is a need for back-up in the form of equality bodies, ombudsmen for equality and reliable independent advice.

Environmental Protection

On March 5, the European Commission adopted a proposal which will lead to the imposition of criminal sanctions on those responsible for pollution by ships. A measure of this type is particularly important in shipping as the existing civil liability regimes for pollution by ships do not provide sufficient financial disincentives for such cases. The proposed Directive establishes that marine pollution by ships is a criminal offence and sanctions will be applicable to any person - including the master, the owner, the operator and the charterer of a

ship and to the classification society - who has been found to have caused or contributed to illegal pollution intentionally or by means of gross negligence. The penalties may, in the most serious cases, include jail sentences. The proposal responds to calls by the European Council in Copenhagen on 13 December 2002 for further specific measures relating to liability and corresponding sanctions and by the Transport Council of Ministers on 6 December 2002 and the Justice and Home Affairs Council on 19 December for strengthened protection of the environment and criminal sanctions for grossly negligent behavior leading to marine pollution by ships. The proposed Directive provides detailed rules for the discharge of polluting substances, including oil and chemicals. The Directive will fill significant regulatory gaps in community law and will strongly contribute to establishing a culture of responsible shipping in EU waters and beyond. The newly created European Maritime Safety Agency will assist the Commission and Member States in establishing the information system required to effectively implement this Directive.

Companies

On March 4, 2003, the European Commission launched open consultations on two projects in the field of EU company taxation. One concerns the possibility of using International Accounting Standards (IAS) as a starting point to develop an EU-wide consolidated tax base for companies. The other involves a "Home State Taxation" pilot project for Small and Medium Enterprises, which would allow an SME to account for its EU-wide profits in one tax declaration which it would submit to Member State where its main office is located. The Commission's services have prepared a consultation document which sets out in detail the various arguments and technical issues related to using the IAS as a starting point for an EU-wide tax base for multinational companies. All listed companies, including banks and insurance companies, will be required to prepare their consolidated accounts in accordance with the IAS from 2005 onwards. As far as the pilot project is concerned, the concept of home state taxation, which was discussed at length in the Commission Communication and study of October 2001, aims at allowing businesses to opt to compute their consolidated tax base at EU level according to the rules of the Member State where their headquarters are based. This document launched the idea of a pilot scheme allowing SMEs to benefit from such a system and discusses in detail the relevant technical points and alternative possibilities. The suggestion is that SMEs as a group would particularly benefit from a home state taxation system because of the specific tax problems they encounter when engaging in cross-border and international activities. For instance, tax compliance costs in an international context seem to be regressive in relation to the size of the company and are often, therefore, disproportionately high for SMEs. Furthermore, the absence of rules in many Member States allowing the offsetting of cross-border losses hit SMEs particularly hard, especially as regards start-up losses that almost by definition occur in the first years of an international investment.

With regard to market abuse, on March 10, the Commission released three working documents related to the Directive 2003/6/EC on market manipulation (i.e. market abuse). These working documents have been drawn up following the advice given to the Commission by the Committee of European Securities Regulators after an extensive consultation process. These working documents can be found on the European Commission's website http://europa.eu.int/comm/internal_market/en/finances/mobil/market-abuse_en.htm. This is the first time the Commission has published such working documents for the sake of transparency. The three working documents cover the following measures for implementation: definitions of inside information and market manipulation as well as public disclosure of inside information by issuers (Articles 1 and 6, paragraphs 1 and 2 of the Directive); fair presentation of recommendations and disclosure of relevant interests or conflicts of interest (Article 6, paragraph 5 of the Directive); and the so-called "safe harbor" - i.e. conditions for exemptions from prohibitions of insider dealing and market manipulation in specific cases (Article 8 of the Directive).

Genetically Modified Organisms

On March 5, the European Commission held a policy discussion about co-existence of genetically modified, conventional, and organic crops. The Commissioners addressed the concept of co-existence, preparatory work carried out so far, possible farm management measures, the feasibility of GM-free zones and liability for adventitious presence. The Commission also discusses policy options and action to be taken on the national and EU levels. The Commission noted that co-existence concerns the economic consequences of adventitious presence of genetically modified crops in non-GM crops. The issue has its origin in the principle that farmers should be able to cultivate freely the agricultural crops they choose, be it GM, conventional or organic. No form of agriculture should be excluded in the EU. This discussion will serve as a basis for a round table on co-existence on 24 April 2003, where stakeholders will have their say. The Commission will then speedily table guidelines on how to address the issue of co-existence of different crops.

THE EUROPEAN UNION ECONOMIC NEWS

Commission's Proposal for Adapting the Financial Framework for Enlargement

The European Commission presented its proposal for adapting the financial perspective for 2004-2006 to meet the demands of enlargement. This proposal sets in motion the process of incorporating the ten new Member States into the

EU budget, within the limits of the financial perspective for the six candidate countries agreed at the Berlin Summit in 1999. The Council and the Parliament will have to set the framework for the next three budgets on the basis of this proposal.

The proposal meets expectations of both the old and new Member States, as it remains within the ceilings set in 1999 in Berlin, but at the same time, all the new Member States will be net beneficiaries from the day they join the Union. The proposal provides for the current categories of expenditure to be adjusted in line with the enlarged Union. The EU budget for 25 Member States will no longer distinguish between old and new Member States. Under the proposal, the forthcoming 2004 budget will total 1.12% of the GNP, or EUR 115 billion in commitments, and 1.08% or EUR 111 billion in payments. The proposal involves no change in the ceiling set for payments in Berlin, while the ceilings for commitments are even slightly lower than in 1999.

In concrete terms, the ceilings for agriculture and Structural Funds, internal policies and administration are to be increased by the amounts agreed by the Council in Copenhagen. For agriculture and the Structural Funds there is a provision for a gradual increase in direct payments to farmers. As regards internal policies, the programs are to be fully extended to the new Member States. This heading will also include new special facilities for better control at external borders, as well as facilities for nuclear safety and for building up administrative and institutional structures.

The current ceiling on pre-accession aid is to remain unchanged. The Commission proposed a step-by-step increase in funding for Bulgaria and Romania of up to 40% a year between 2004 and 2006. The target is to make EUR 1228 million available for the two countries in 2004, reaching EUR 1432 million by 2006. Funds for Turkey are set to double at least by 2006, as well.

The proposal includes the creation of a new heading for compensatory payments to be made to the acceding countries in the form of a temporary flat-rate cash – flow facility. This facility will be available in the amount of EUR 1410 million in 2004, shrinking to EUR 1041 million in 2006. It is intended to ensure that the new Member States are no worse off than before accession, in other words that they can remain net beneficiaries.

The Third Report by the European Commission on Implementation of the EU Social Policy Agenda

The social policy agenda is the EU's roadmap for modernizing and improving the European social model by investing in people and building an active welfare state. It promotes the Lisbon strategic objective of strengthening the EU's economic dynamism, creating full employment with quality jobs and promoting social cohesion. The European Commission released its third annual scoreboard report on the implementation of the social policy agenda, which, among other

things, anticipates the main points of the mid-term review of the Social policy Agenda which will take place in 2003.

The Report shows that the agenda is still on schedule and that it has helped the creation of 2.5 million new jobs in 2001-2002. Employment creation is expected to continue with about 500,000 new jobs in 2003, but the unemployment rate is projected to increase somewhat at the same time from 7.6% in 2002 up to 7.7% on average over 2003. The unemployment rate in the Euro-zone is anticipated to reach up to 8.5%.

Despite improvement in the employment rate, pervasive weaknesses on the labor market remain and need to be addressed urgently. These include:

- continuing high levels of unemployment and long term unemployment;
- persistently low employment rates for women;
- age-related difference in employment rates;
- immigrants, people from ethnic minorities and other disadvantaged groups are still confronted with significant obstacles on the labor market;
- the regional differences in several Member States which affect the Union's social cohesion;
- the persistence of regional labor market bottlenecks and skill shortages.

In order to reach the Lisbon targets by 2010, another 15 million additional jobs need to be created. Thus, the positive path of labor market reform must be continued in the new, more focused European Employment Strategy.

The Report stresses that the structural weaknesses identified in the labor market are to a large extent responsible for the persistence of poverty and social exclusion. However, other factors are to be considered such as the lack of basic skills, and ill health or disability. On the other hand, a job may not be sufficient to afford workers the necessary means to escape poverty and social exclusion, particularly where work is associated with low wages, poor task quality, precarious employment terms or insufficient training.

The latest available income data shows that 15% of the EU population, or about 56 million people, are at risk from poverty (living below a threshold of 60% of the national median equivalised income), while 9 % of the EU population is at a persistent risk of poverty. Social security is crucial to reducing the risk of poverty. Without welfare transfers, the risk of poverty would have been 40 %.

The Lisbon strategy must shape all action designed to promote employment and social policy in the EU. This means that policies should be geared towards maximizing the positive interaction between economic, employment and social policies. This is why the role of social policy as a productive factor is crucial in the formulation of policies and why the cost of suboptimal social policies will be featured strongly in the mid-term review of the Social Policy Agenda that will take place in the first half of this year.

***The Commission Has Adopted Favorable Opinion on the Accession of
Ten Candidate Countries***

The European Commission has adopted a favorable opinion on the accession to the Union of ten applicant countries: the Czech Republic, Estonia, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, Slovenia and Slovakia. Taken in accordance with Article 49 of the Treaty, the decision follows the successful conclusion of the accession negotiations at the European Council meeting in Copenhagen on 13 December 2002 and the finalization of the Treaty of Accession in the first half of February 2003.

The Commission's work started with the opinions on the applications of the ten countries which were adopted on 30 June 1993 for Cyprus and Malta (updated for Malta on 17 February 1999) and on 15 July 1997 for the Czech Republic, Estonia, Latvia, Lithuania, Hungary, Poland, Slovenia and Slovakia. The Commission has played a crucial role in the accession negotiations, up to the final moments in Copenhagen. The Commission has also provided the present and future Member States, and the citizens of these countries, with an in-depth analysis in its yearly Regular Reports on the progress made by each of the candidate countries towards accession. The most recent ones, adopted on 9 October 2002, concluded that the Czech Republic, Estonia, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, Slovenia and Slovakia fulfilled the political criteria for membership and that they will have also fulfilled the economic and *acquis* criteria for membership by the beginning of 2004. On that basis, the Commission recommended the conclusion of the accession negotiations with these countries by the end of 2002 with the aim of signing the Treaty of Accession in spring 2003.

The Commission is confident that the acceding states will pursue the reforms that need to be carried out in view of their accession, in line with the commitments they made during the negotiations. The Commission will continue to monitor the fulfillment of these commitments and obligations until accession, and will assist them with the available instruments.

In accordance with Article 49 of the Treaty on European Union, the decision to admit an applicant State to the European Union is taken by the Council, after consultations with the Commission and after having received the decision on assent of the European Parliament.

The adoption of the Commission's Opinion is the first step in this procedure. In accordance with the timetable established by the Greek Presidency, in agreement with the European Parliament and with the Commission, on making possible the signing of the Treaty of Accession in Athens on 16 April 2003, the decision on assent of the European Parliament is planned to be taken on 9 April 2003 and the Council's decision is to follow on 14 April 2003.

The Accession Treaty needs to be ratified by the 25 present and future Member States and will enter into force on 1 May 2004.

Unemployment in Candidate Countries

The European Commission has adopted a report on the labor market situation in twelve candidate countries (report on Turkey in preparation) and the employment policy challenges which they face in the run-up to enlargement starting in 2004. The report states that candidate countries have made progress in transforming their labor markets and in adjusting policy design towards the objectives of the European Employment Strategy and the Lisbon process (creation of 15 million new jobs by 2010). However, the report makes clear that there are significant differences between the candidate countries' performances and that there is, in general, an urgent need to increase employment rates, to increase employment in services, to reduce reliance on agriculture and traditional industrial sectors and to increase skill levels.

The report identified four main strategic priorities for the labor markets of candidate countries:

- Increasing labor supply and bringing back major parts of the working-age population into the labor market is a precondition for economic and social development.
- Increasing employment rates which, together with high productivity growth, are a key condition for strong economic growth, for real convergence of incomes and for the achievement of the Lisbon and Stockholm employment targets.
- The functioning of the labor market needs to support the restructuring of the economy and the labor market must enable people to manage economic change and to move from declining to modern industries.
- Increasing skill levels against the background of an ageing labor force, of restructuring and of future pressures linked to adjustment to the single market and increasing productivity to the levels required for competitiveness in an enlarged EU.

The most recently available data show that, if enlargement were to happen today, the employment rate of EU25 would be 62.6%, and of EU27 62.4%. The employment rate of EU15 is 63.8%. The Lisbon strategy sets an intermediate target for the EU employment rate of 67% in 2005. Average GDP per capita in the EU would fall by 13% in EU25 or by 18% in EU27, according to present data. This report will guide candidate countries in shaping their 'national development plans' setting out employment and human resource policies, including use of the European Social Fund, which are to be submitted to the Commission in the first half of this year. The Commission will present a further progress report on candidate countries' labor markets in autumn 2003.

Source: "Midday Express", http://europa.eu.int/comm/press_room/index_en.htm

THE IMPACT OF THE ENLARGEMENT OF THE EUROPEAN UNION ON ECONOMIC INTEGRATION

The fifth enlargement of the European Union, which is due in May 2004, means the incorporation of several countries of Central and Eastern Europe (Hungary, Poland, Slovakia, the Czech Republic, Slovenia, Estonia, Latvia and Lithuania) and two Mediterranean countries (Malta and Cyprus) into this, above all, economic integration. These countries report significantly lower income levels than those registered in the current EU Member States; almost all these countries (in particular CEE countries) are in the process of transition towards a market economy, and the success of their accession depends on this process. As opposed to previous enlargements, the present candidate countries have to implement a considerably wider scope of legal regulations, most of them relating to the establishment of a single market. At the same time, they already enjoy many benefits reserved for EU Member States by using instruments of strengthened enlargement policy and through the strategy of pre-accession (which includes adjustment to accession costs, as well).

Not only did the experience of previous enlargements of the three Communities, and later of the Union, do no harm to its decision-making process politically, or disturb further integration (but, quite the opposite, it even stimulated it), but it also did not cause any economic disturbance to the Union. Thus, for example, the accession of Greece (1981) and Spain and Portugal (1986), which were low-income countries, primarily affected the change of the budget structure of the Union. On the other hand, the 1995 enlargement, with Austria, Sweden and Finland as new members, increased *per capita* income in the Union, resulting in a positive net inflow into the EU budget.

The new enlargement puts completely different economic challenges before the Union – namely, future members are considerably poorer than the present Union members. Thus, 100 million new citizens of the Union will increase the EU's gross revenue by as little as 5%. As wages paid out to workers in these countries are much lower, the first effect of the enlargement of the Union is expected to be a great labor force migration from the East to "old" EU members. Due to structural transformation which must follow membership, the inflation rate is expected to rise, accompanied by a negative contribution to the EU budget by new members for a longer period. This will certainly affect numerous common policies and

institutions of the Union, as well as labor force migration, financial and budgetary provisions and monetary policy.

The question logically arises whether states that are due to become EU members as of 2004 will have appropriate economic and organizational structures that will allow them efficient participation and contribution to the policies and goals of European integration, and whether the admission of new members will have any significant impact on the coherence of the single market and on the attainment of the main goal of the Union (defined at the Lisbon Summit), i.e. development of the Union as the most competitive and cohesive area for doing business in the world.

We may use the criteria for membership that were defined in Copenhagen in 1993 as a key element for an objective assessment of the capability of future members. These criteria put emphasis on the process of transition, stressing that new members must have an active market economy, ability to respond to conditions of competition and market forces in the Union, and ability to undertake obligations deriving from membership. In its annual reports, the Commission used the existence of a market economy and the capability of sustaining competition as criteria for assessing successfulness of applicant countries, and on the basis of these criteria, in October 2002, it recommended to the Council to admit ten countries for membership. However, it is very difficult to examine the degree of fulfillment of the third criterion, especially because many key policies of the Union and their elements will become obligatory to a certain state only after it becomes an EU member.

Income level or the level of economic development in candidate countries is obviously not taken as a criterion and a condition for membership in the Union; on the other hand, economic development of candidate countries is at the centre of many variables related to the economic impact of enlargement. Some significant variables are interesting both for the Union and its researchers, as well as for acceding countries – e.g. labor force migration, structural funds and, in particular, agriculture.

Is There a Danger of Influx of Migrants From New Member States?

Labor force migration is often stressed as a possible problem of the enlargement, especially because of the previously mentioned sharp differences in the price of labor between Member States and Candidate Countries, as well as because of physical closeness of the territories of Candidate Countries to the Union's Member States. Many are worried because of this, and many are impatiently looking forward to a sizeable movement of workers from Eastern to Western Europe. However, in the opinion of the Directorate General for Economic and Financial Affairs of the European Commission (*The Economic Impact on Enlargement*, Enlargement Papers No. 4, 2001, DG ECFIN), enlargement is not very likely to have any significant impact on employment and wages in the Union, as their analyses show that the total inflow of migrants from the East

account for as little as one percent of the employed in the Union. It is interesting that the number of migrant workers decreased during the 1990s: in 1990, 330,000 migrant workers entered the territory of the Union, while in 1997 this figure shrank to 14,000.

Hence, the total impact of enlargement on the employment rate in the Union is irrelevant. However, it should be borne in mind that this impact will be concentrated in certain states and regions, in particular in Germany and Austria. Workers from CEE countries legally employed in the EU constituted 0.2% of total employment in the Union in 1998; out of this percentage, 80% of CEE workers legally worked in Germany and Austria, thus constituting 0.5% and 1.1% of the total labor of these two countries. This brings about another problem that is more political than economic – how to ensure support for the process of enlargement in these countries and regions. The only solution offered so far refers to transitional periods during which free movement of the labor force from the new Member States will be limited, which will leave time for adaptation to the new environment for the most affected states and regions.

The necessity of adaptation, especially as far as common citizens are concerned, is confirmed in the Poll conducted by the Opinion Poll Center of the European Parliament in December 2002 (<http://europoll.ibicenter.net>), where we can observe very interesting public positions on some questions regarding the impact of enlargement. Namely, respondents from EU Member States in 50% of cases expect enlargement to increase unemployment in the EU, while respondents from Candidate Countries share this opinion in only 25% of cases. This difference is even wider with regard to the question whether enlargement will make it more complicated for the EU to operate, which is expected by 80% of respondents from the EU, against 40% at most in Candidate Countries.

Enlargement Costs Covered from the EU Budget

Given that labor force migration will not appear as a major consequence of enlargement of the Union, the main economic impact should be sought in new budget pressures. Namely, the question is whether and to what extent the present Member States will have to finance enlargement toward Eastern Europe, primarily through common policies that are funded from the budget. The most interesting are the Common Agricultural Policy and Structural Funds, which constitute nearly 80% of all budget costs. The latest financial agreement on the budget for the period 2000-2006 was made in 1999 (Summit of the European Council in Berlin), but no long-term decision regarding the financing of enlarged Union has been made on that occasion.

In previous enlargements, the budget of the Union balanced the costs of adaptation of new members by allocating resources for enlargement. Even for much richer countries, such as Austria, Finland and Sweden, sufficient resources were allocated for financing their less developed regions. However, the position of states which are net contributors to the Union's budget is a clear refusal of

any significant increase in the budget – Germany, Austria, Sweden and the Netherlands even want to reduce their contributions to the Union's budget. For these reasons, the majority of assets from the budget are still intended for the current 15 Member States, even after enlargement; resources that the Union allocated for new members are modest, amounting to EUR 67 billion for seven fiscal years. It is interesting that this amount is equal to as little as ten percent of resources granted to East Germany after unification (about EUR 600 billion for the period 1990-1999). This implies that the impact of enlargement on EU's public finance is an issue that is rather political than economic. Real enlargement costs, which have to be paid by the Union's citizens, will depend solely on the political decision on how generous the Union will be. At present, there is no justification for the claim that this will require substantial allocation from the budget, in spite of the fact that these states are far poorer, with the reason being that the current Member States have decided to reallocate a relatively small amount of funds for enlargement - less than 10% of the total budget.

a. Structural Funds and Enlargement

The exploitation of Structural Funds is another controversial issue, in particular due to the pressure of the current Member States. Namely, Structural and Cohesion Funds are designed for less developed Member States and for less developed regions within the Member States. These funds are the main instruments for balanced development of the EU as a whole in attaining its goal, defined as stronger cohesion within the Union.

The shrillest opponent to the extension of structural funds to new members is Spain, a state which is fiercely fighting to keep these funds for financing its own poor regions. This is quite understandable, given that Spain enjoys nearly 2/3 of all Structural and Cohesion Funds on the basis of the existing budget agreements. However, after enlargement, only the two poorest Spanish regions will keep the status of undeveloped regions and will continue to receive assistance from these funds on that basis.

According to EU regulations, the major part of these funds is available to regions in which GNP is below 75% of the Union's average. This practically means that after the accession of CEE countries, all regions that meet these criteria will be CEE regions, since after the enlargement, GNP will decrease under the level of today's poorest regions.

The ongoing reform of Structural and Cohesion Funds foreseen in the Agenda 2000 projected the total amount of EUR 213 billion for these funds, and nearly EUR 60 billion for 2004, 2005 and 2006 respectively. Hence, after accession, one-sixth of the money from the Structural Funds will be available for assistance and programs to new EU members. Structural Funds will be a significant element in developing the cohesion of new member states, but at the same time this involves a considerable transfer of money, given the low income levels in Eastern Europe.

b. Agriculture

Agriculture is a very important political area not only because it accounts for considerable budget expenditures (about 40% of the budget), but also because agriculture is the main sector in many future Union members, both in terms of output and the number of workers. Actually, agriculture appears as a problem because of potential costs of spreading the Common Agricultural Policy (CAP) in its present form to the farmers from CEE countries. It is understandable that unlimited accession to agricultural funds in their present form will be very expensive, since the Union would have to pay guaranteed prices and subsidize production of agricultural producers from these states as well, as it subsidizes farmers from the EU Member States today. Poland is the greatest problem, since almost one-fourth of its citizens live on farming. That is why the EU has already refused the request of Poland relating to transitional periods, which Poland had to accept in order to fully respond to the requirement of future membership.

However, the problem is not the system of agriculture that exists in CEE countries – quite the opposite, small farms with extensive, organic production which does not violate ecological requirements and the environment present exactly what many experts advocate as the ideal of agricultural production in the EU. The problem for Candidate Countries is the fact that the CAP is a constantly evolving objective and it is therefore necessary to adjust food safety standards before the beginning of membership in order to make possible export to a single market.

The main problem of enlargement with regard to agriculture is that this very badly defined policy becomes even more difficult in terms of effectiveness, given trade obligations prescribed by the World Trade Organization which refer to the nature of agricultural production and increased emphasis on rural development and environment protection. Enlargement will increase the need for reform and redrafting of agricultural policy, with the aim of defining modern goals in accordance with global obligations.

Because of these requirements, Common Agricultural Policy of the Union is in the process of permanent transformation. After reform from 1992 (so called MacSharry Reform) and the Berlin Agreement (1999), in the course of 2002 a medium-term reform was carried out, but this issue will be on the agenda again, when financial prospects for the period after 2006 become clear. This problem becomes even more complicated given the fact that reforms of the CAP, enlargement and obligations under the WTO are mutually connected and conditioned.

Enlargement as Economic Gain for the EU

Although costs, shocks and adjustments are likely in the short run, the frequent often medium-term and long-term estimations stress that economic gain will

significantly exceed economic costs over the same period. Enlargement will increase the number of consumers on the single market by over 100 million, which will result in new jobs both in new Member States and in the Union. On the other hand, although this concerns former communist countries which used to have centralized economies, they have crossed a very difficult path of the transition so far in their attempt to come closer to the Union, and today they are at the doorstep of Europe because of their success in the process of transition. Another fact should be borne in mind as well – all these economies are small and are developing much faster than the existing EU markets. Enlargement opens opportunities for foreign direct investments which are of key importance for growth and integration of these economies into a single market.

As far as long-term enlargement benefits on the part of the Union are concerned, we must not forget the fact that 25 states will be doing business under the same rules, within the same regulatory framework which is organized as a hierarchical system of norms and institutions. At the top of this hierarchical structure of norms and institutions is a judicial body, the Court of Justice of European Communities which has proved its capability precisely in the creation and preservation of a single market. New members must conform and adjust to this regulatory system, and in this way almost the whole of Europe will start moving toward the creation of a common competitive trade area, which is maybe the greatest benefit of the future and of every other enlargement.